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Relational Contracts

## Relational Contracts:

The New Generation Of Franchise  
Agreements

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**RELATIONAL CONTRACTS:  
THE NEW GENERATION OF FRANCHISE AGREEMENTS**



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# RELATIONAL CONTRACTS: THE NEW GENERATION OF FRANCHISE AGREEMENTS



## EXECUTIVE SUMMARY

The vast majority of written franchise agreements can be described as ‘transactional’ contracts. The typical franchise agreement sets out at great length the parties’ rights (mostly the franchisor’s rights) and obligations (mostly the franchisee’s obligations). But is this the way it should be?

This paper argues that the franchise industry should seek a new standard, one the authors refer to as a **formal relational contract**. Why? The very nature of the close legal and business relationship between a franchisor and a franchisee embodies far more than the actual wording of their written franchise agreement. The purpose of this paper is to bring practical insights and understanding into the why, what, how, and when of using a formal relational contract for franchising. This paper is divided into five sections:

**Part 1:** Illustrates the problem of the contracting paradox and why there is a need to change

**Part 2:** Provides a high-level introduction to relational contracting

**Part 3:** Seeks to explain why the franchise industry needs to make the shift to relational contracting

**Part 4:** Aims to help organizations understand the ‘what and how’ to develop a franchise relational contract

**Part 5:** Summarizes the example of a great franchisor: McDonald’s ‘Secret Sauce’

We end the paper with a short conclusion and call to action with advice for getting started.

You might be thinking “what’s in it for me to read a 50+ page paper on the boring topic of contracts?” First, this is not an academic paper; rather it is a practitioner’s guide written to challenge individuals who play a role in forming or managing franchise relationships to understand a proven approach for contracting which can and should be applied to franchise contracts. Second, we think you will find this paper enlightening if not outright evocative.

As you ponder the power and potential of relational contracting for franchise relationships, we believe you will have a better understanding of why a shift from conventional franchise transactional contracts to formal relational contracts can be an enabler for franchisors and their franchise networks to create healthy and more sustainable relationships. At a minimum, we think you will find yourself asking: “Why would I not want more effective and efficient franchisor-franchisees’ communications, clarity over objectives, a culture of accountability and continuous improvement?” You may even conclude that franchise relational agreements should be used much more widely.

**Last, we hope this collective work becomes the reference guide for franchise relational contracting.** Knowledge is power, and knowledge shared is exponentially powerful. This paper is open source and is fully sharable.



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## **PART 1: WELCOME TO THE CONTRACTING PARADOX**

Like many other organizations, more and more franchisors are facing a *contracting paradox*.

Contracting is about planning for future business exchanges, and about how to deal with the risks and opportunities entailed in such exchanges. Yet today – more than ever before – the search for the perfect plan is painful, if not impossible. Today’s market is faster, more global and more complex than ever before. Change is the new constant, making accurate planning and forecasting almost an illusion.

Psychological research has revealed the troublesome fact that evolution has made us ill-equipped to make good plans *and* at the same time well-equipped to believe we are good planners.<sup>1</sup> The result is a planning fallacy leading to the *contracting paradox*.

So, what is the contracting paradox? It is the delusion we write contracts to make plans, but we cannot really plan accurately. And, as a nice twist, we trick ourselves into believing we can plan.

The contracting paradox is a recent phenomenon. For centuries, much of the business world ran on ‘handshake’ deals. When Professor Stewart Macaulay researched the use of contracts in 1963, he discovered that: “Businessmen often prefer to rely on a ‘man’s word’ in a brief letter, a handshake, or common ‘honesty and decency’ – even when the transaction involves exposure to serious risk.”<sup>2</sup> At about the same time, legal scholar Ian Macneil coined the term *relational contract*, referring to the social contract of moral obligations guiding behavior in business that Macaulay and others had discovered.<sup>3</sup>

However, it was also around this time that legal scholars and practitioners began what was the start of a significant trend to create more formalized ‘complete’ contracts to document business agreements. As the decades passed, contracts grew longer and more complex, including more and more detailed plans trying to deal with an endless list of ‘what-if?’ questions.

As informal moral norms were replaced with formal contractual obligations, the old relational contract was therefore replaced with the more formal *transactional* contract that now dominates as the primary approach for contracting, especially in franchising. Today, it is not uncommon for a franchise agreement to count more than 80 pages with many having several schedules and ancillary agreements. And, on top of that, franchise agreements almost always refer to an operation manual (in printed or electronic format), which is often several hundred pages.

In short, the legal experts drafting these transactional contracts are striving for the ‘complete’ contract that tries to address all ‘what-if?’ possibilities. But, despite their best

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efforts and contracts that run into hundreds of pages, they are not bulletproof - and will never be.

More importantly, many of these extensively detailed agreements fail to deliver the desired results.

It is argued by some that their content and the process that supports their formation actually detracts from the chances of success. Practitioners cite value leakage from contracts and contractual relationships and there are many reports of good deals gone wrong or bringing the parties before a court of law. This has led to increasing questions over the effectiveness of contracts and the contracting process. But then we have to face the contracting paradox. To succeed in business (and in franchising), we cannot give up planning. But now we know how poor we are at planning.

What can happen when you find your well-laid plans and associated contracts fall short of expectations?

One example is KFC's 2018 plan to shift its UK distribution partner from Bidwest to DHL, which failed miserably. KFC and DHL surely thought they had planned the transition well and addressed risk in the contract appropriately. But that was before KFC started running out of chicken at more than half of its 900 restaurants in the UK. The shortage led to store shutdowns across the UK and, ultimately, KFC shifted its distribution back to its original supplier.

One might simply blame the supplier. But there are often two sides to a story as suppliers often blame the client.

And what about all those plans and contracts that don't result in a highly public court battle or embarrassing social media disaster?

The point is simple: complex contracts are inherently incomplete. It is impossible to plan for every contract eventuality.

To abandon the detailed transactional contracts and return to the nice and cozy world of handshake deals is not perceived as an attractive alternative for most companies working in a global world where contracts are most often made between people who don't know each other. It is simply perceived, and rightly so, as too risky.

But there is hope. A growing number of organizations have found ways out of the contracting paradox, reducing the value leakage while becoming better and better at dealing with the uncertainty and complexity of the modern economy. What we see is the *return of the relational contract*, but in a new form. Today's relational contract is not the informal 'handshake' deal from a bygone era, but rather a formal relational contract depicted by a highly collaborative relationship where the parties consciously choose to

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make social norms contractually binding. Modern relational contracts also explicitly describe joint governance processes within which the parties can work together to deal with risk and uncertainty.

There is an undeniable and growing amount of research showing how and when relational contracts outperform conventional transactional contracts in terms of cost advantages, time, quality and innovation. Researchers at the University of Tennessee and organizations such as the International Association for Contract and Commercial Management (IACCM) are squarely behind the movement to help individuals and organizations understand and make the shift to using the modern form of relational contracts when appropriate.

It is time to embrace the contracting paradox and stop trying to write a contract for the perfect plan. Instead, embrace a flexible contracting framework designed to keep the parties aligned when ‘business happens.’

### Today’s Current Franchise Contracting Environment

The vast majority of written franchise agreements can be described as ‘transactional’ contracts. The typical franchise agreement sets out at great length the parties’ rights (mostly the franchisor’s rights) and obligations (mostly the franchisee’s obligations).

However, it can be argued the very nature of the close legal and business relationship between a franchisor and a franchisee embodies far more than the actual wording of their written franchise agreement. But what more? According to a landmark judgment rendered by the Court of Appeal of Quebec (Canada) on April 15, 2015, between Dunkin’ Brands Canada Ltd. and several of its Quebec franchisees,<sup>4</sup> the court refers to the “what more” as a “relational contract.”

But what is a relational contract and how does it relate to a franchise agreement? In 2004, a Canadian law scholar, Shannon Kathleen O’Byrne, defined the franchise “relational contract” in the following manner:

*“/.../ the franchise contract is an incomplete contract since the parties cannot possibly recite all their rights and obligations in advance.*

*As Hadfield<sup>5</sup> notes: “Often, contracts are necessarily and intentionally incomplete because mutual desires for flexible, but bounded, responses to uncertain future conditions limit the scope and precision of verifiable terms.” The good faith doctrine is deployed to fill in the blanks as they arise.”*

*/.../on a related front, the franchise contract is the quintessential relational contract. As articulated by the American contracts law scholar Ian Macneil,*

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*relational contracts contrast with the instantaneous exchange that characterizes discrete (or 'one-time') contracts like purchasing a car or buying a house. The relational contract is one where the parties have obligations over time and are thereby linked by the norms of reciprocity, flexibility, contractual solidarity, restraint of power, and propriety of means, to name a few examples.*

*Though classical contract law would characterize these norms as both imprecise and inappropriate, recent case law demonstrates that the franchise contract cannot be safely assessed from such a traditional vantage point. Instead, via the obligation of good faith, relational norms form the backdrop of the franchise agreement and generate its content.”<sup>6</sup>*

What this means in practice is the success of a long-term franchise relationship must go beyond the static text of a transactional agreement initially signed. Success requires a mutual commitment to collaborate, evolving and changing over the life of the relationship. Each party must play its role so the considerations behind the franchisor-franchisee agreement are not voided or defeated for either party. That commitment also calls for maintaining a high degree of good faith and mutual loyalty throughout the relationship.

Paradoxically, the strength of a relational contract derives not from the written transactional agreement, but from positive relational behaviors and mechanisms almost always found outside of the written contract. In essence, a relational contract comprises the rules needed for maintaining the close collaboration that the parties are seeking over the long-term of their legal and business relationship. For example, how the parties interact and collaborate as they seek to balance both common and diverging interests over the long-term.

Of course, the individual objectives of the franchisor and of each franchisee are the success and profitability of its own business. This often calls for negotiations about how the revenue generated by the network is to be divided between them. In the quest to develop the terms and conditions of a franchise agreement, it is paramount for the franchisor and for its franchisees to realize neither of them can succeed or maximize its profitability if the other fails or becomes unprofitable in the long-term. This creates a mutual obligation to maintain a delicate balance between the entirely understandable objective of each party to increase its own profits, and the commitment of each party to contributing to the ongoing collaborative relationship in which each must benefit.

Several studies have focused on numerous franchise networks, including those done by Greg Nathan.<sup>7</sup> The research concludes the quality of the collaboration between a franchisor and its franchisees rests far more on adherence to the relational contract than to the written transactional agreement.



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Those studies show it is possible to predict, with high accuracy, the probability that franchisees will willingly agree to comply with their franchisor's rules, policies and directives and to participate in its initiatives and programs, on the sole basis of their answers to these two questions:

1. Do the decisions made and the actions taken by my franchisor's executives show they genuinely make the success of the entire network (which comprises both the franchisees and the franchisor), as a whole, their priority over the individual interests of the franchisor alone (in other words, "Are they reliable")?
2. Do my franchisor's executives really know what they are doing, where they are going, and how to manage the network (in other words, "Are they competent")?

Simply put, when franchisees perceive its franchisor have an interest in franchisees' success and that the franchisor's executives are competent, such perception creates a trusting environment which is a strong predictor of a healthy franchisor-franchisee relationship.

Conversely, when franchisees believe that their franchisor is concealing important information from them, is making bad decisions, is not demonstrating leadership and competence in its management of the network, or is putting its own interests ahead of those of the network as a whole, they will interpret those actions as breaches of the relational contract between franchisor and franchisees.

There is then a strong risk that the franchisees will react to this 'unfairness' (in their perception of the situation). For example, in the landmark Canadian case involving Dunkin' Brands Canada Ltd. (to which we referred earlier), between 2000 and 2004, the franchisor initiated several plans and projects to improve the competitiveness of its franchises, which was then in serious difficulties in the Quebec market. Unfortunately, when these were put forward by the franchisor, the Dunkin' Quebec franchisees then had lost any confidence in both the franchisor's executives' competency (at least regarding the Quebec market) and in the franchisor's interest in the franchisees' success. With such a perception from its franchisees, it has been impossible for the franchisor to execute any further initiatives, plans or strategies to improve its franchise network's situation in the Quebec market as the franchisees would not collaborate any more with it. Within a period of ten years (between 1998 and 2008), the Dunkin's franchise network in the province of Quebec melted from 210 stores to 10 stores, and has since completely disappeared from the Quebec market in which it was previously, and for many decades, the dominant player.<sup>8</sup>

So, what does this mean to today's franchise relationships? Simply put, the wording of their written franchise transactional agreement only plays a very secondary role as compared to the feeling of unfairness resulting from those perceived breaches of the relational contract.



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Another fundamental characteristic of the franchisor-franchisee relationship is its long-term nature. The typical franchise agreement generally runs between 10 and 25 years when you factor in renewals. This inevitably causes important challenges because franchise networks regularly face the challenges associated with evolving regulatory and business changes (new laws and regulations, amendments to existing laws and regulations, new technologies, new direct and indirect competitors or substitutes, etc.).

Experience proves that it is impossible for a franchise transactional agreement to provide for all changes that will occur over the term of the agreement. For example, most franchise transactional agreements drafted only a few years ago contained no provision for how to deal with e-commerce or social media issues that now constitute very important challenges for most franchisors and franchise networks. Even today, most franchise agreements do not yet contain provisions regarding the impact and consequences on the franchise systems of on-line market places and peer-to-peer sharing applications (like Uber, Airbnb, JustEat, etc.).

The reality is franchisors are facing a dilemma. They have long term detailed franchise transactional contracts, but need the flexibility to incorporate important changes and challenges as they occur. Franchisors have two options: (a) negotiating contract amendments with all of their franchisees, or (b) deviating from the written terms and conditions of their transactional agreements with the risk of non-compliance by, and of legal recourses from, one, several or even all their franchisees (including class actions).

More and more are we seeing courts adding 'relational' rights and obligations to these transactional agreements and franchisors having to deviate from the written provisions of the agreements signed with many (sometimes hundreds of) franchisees to ensure the sustainability of their franchise networks in ever-changing markets and contexts.

The question becomes what to do when faced with the contracting paradox. Can a franchisor and its franchisees have an agreement well-suited for long term collaboration of legal and business relationships?

We argue the relational nature of the franchisor-franchisees relationships can be reflected in a *formal* relational contract. Such an agreement is based on the mission, the values and the objectives of their own franchise system. Further, we argue it is in the best interest of franchise networks to proactively restructure their existing (and often outdated) transactional agreements to formal relational contracts rather than wait for the courts to add 'relational' rights and obligations to what is likely an inadequate and incomplete transactional franchise contract.



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**PART 2: INTRODUCTION TO RELATIONAL CONTRACTS**

Webster's dictionary defines a *contract* as:

- “1. A) *binding agreement between two or more persons or parties; especially one legally enforceable // If he breaks the contract, he'll be sued.*

*B) a business arrangement for the supply of goods or services at a fixed price // make parts on contract*

2. *A document describing the terms of a contract. Have you signed the contract yet?”<sup>9</sup>*

In short, contracts regulate the rules of business between individuals and/or organizations. We write contracts with franchisees, suppliers, customers, business partners, employees, etc. when we depend on others to realize our business plans. But planning is a difficult task, especially in today's complex, global environment. And since we, unfortunately, tend to act opportunistically, we need to agree with others on the joint plans for the future. The result is a contract that outlines the rules we shall follow in our relationship and the parts of our agreements that will be legally binding and enforceable in court. Using the terminology of one of the pioneers of relational contracting – Wigmore Professor at Northwestern University Ian Macneil – contracts should be viewed as “instruments for social cooperation.”<sup>10</sup>

But just what is a *relational* contract?

Let's start by dispelling a myth. Just because it incorporates the word ‘relational’ does not mean it is soft and wooly. In fact, the opposite is true. A relational agreement brings added discipline because it codifies the framework for the relationship – the forums, behaviors and mechanisms within which interactions will occur.

There is an increasing volume of writing and a growing body of case law on relational contracts. Over the decades, legal, economic, and social science research have all provided the foundational underpinnings that point us to defining what a relational contract is—or at least should be. We suggest the best way to understand a relational contract is to compare it to the dominating contract model we call the *transactional* contract.\* Exhibit 1 (following page) provides the comparison along five dimensions, showing the distinct differences between a relational contract and a transactional contract, while at the same time showing these two contract forms exist on a continuum.

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\* Ian Macneil used the term “discrete contracts” for the contract we here refer to as the transactional contract.

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**Exhibit 1: Comparison of Contracting Models**

	<b>Transactional Contract</b>	<b>Relational Contract</b>
<b>Focus</b>	The commercial transaction	The relationship
<b>Relationship</b>	Arm's-length relationship	Partnership
<b>Social norms</b>	Disconnect from social norms	Explicitly includes social norms as contractual obligations
<b>Risk management</b>	Use of power and creation of enforceable contractual obligations	Risk avoidance by creation of continuous alignment of interests
<b>Planning</b>	Aims for complete planning, i.e., contract should cover all future events	Creates a fair and balanced flexible framework

Based on this comparison, which we will return to several times in this paper, we formally define a relational contract, at the far-right end of the continuum, as:

*A legally enforceable written contract establishing a commercial partnership within a flexible contractual framework based on social norms and jointly defined objectives, prioritizing a relationship with continuous alignment of interests before the commercial transactions.<sup>11</sup>*

Today, transactional contracts dominate as the primary contracting vehicle used in business-to-business, including evidently franchisor-franchisee relationships. This is not surprising because usually it is not that complex to do business with others, especially when contracting for the sale or purchase of commoditized goods or services and where there are many suppliers and low switching costs.

However, as the nature of what we are exchanging (more intangible goods or services) and the environment in which we operate (more global, faster changing, less predictable and more regulated) grow more complex, transactional contracts are increasingly riskier because of the extent of the 'incompleteness' or uncertainty in contracts. Incompleteness has grown from an estimated average of around 5% when Ian Macneil was writing in the 1960s to around 35 – 40% today.

Successful business relationships find ways to proactively address this incompleteness in a fair and balanced manner. Traditional contracts are formulated on two foundations – finance and power. Within these parameters, there is little room for shared values or principled governance. Therefore, one of the main reasons organizations fail to implement relational contracting principles into their contracts (moving from the left to the right on the continuum) stems from using conventional contracting processes that are not fit for

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establishing the trust and aligned interests needed to succeed with relational contracting, like between franchisors and franchisees.

For this reason, franchise relational contracting instead proposes using a formal process and framework for mutually creating a relational contract. We explain the rationale behind this suggested step-by-step approach later in this paper.

While we promote using a structured process to create a franchise relational contract, we also recognize many franchisors may find themselves in an existing relationship with many franchisees in which it is impossible to go back and lay the foundation from the beginning.

As mentioned previously, transactional contracts are built around classical legal theories of risk allocation, which often leads to frustrations and tensions, as the arm's length nature of the contract structure encourages more opportunistic and adversarial behaviors.

If this has happened in the franchise network(s) you are involved in, don't become disenchanted because you got out the gate wrong. We encourage you to not give up. Rather, consider embedding as many of the relational focus areas as possible into your existing franchise relationship with the goal to improve the relationship, moving from left to right on the continuum. Whether you start with the formal process we recommend – or you work to embed the relational components into an existing franchise relationship – the investment will pay off.

As you make the shift to relational contracting, it is important to understand why it is essential to add relational contracts to today's contracting toolkit. We start Part 2 of this paper by looking at the world around us and how it has changed during the last thirty years.

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### PART 3: WHY USE FRANCHISE RELATIONAL CONTRACTS?

In 1963 Stewart Macaulay wrote what would become the most cited scholarly legal article in the last century.<sup>12</sup> He reported that most business executives saw little need for contracts and often felt that establishing a contract can ‘get in the way of a good relationship’. A high proportion of trading relationships were long-established and most were geographically or culturally ‘local’.

Fast forward to the 1980s. Global networked technologies and the emergence of new business practices disrupted patterns of trade and behaviors. Long term relationships were discarded in the search for competitive advantage, whether in the name of innovation or cost reduction. The steady growth of global interdependence has come with growing tension and unpredictability. Today’s business environment is often depicted by the term ‘VUCA’ – volatility, uncertainty, complexity and ambiguity.<sup>13</sup>

This shift offered fertile ground for lawyers to perfect the ‘complete’ franchise agreement. The saying “Nothing personal, it’s just business” emerged as a common excuse in the quest for opportunistic behavior. A consequence was greater adversarialism in a battle over financial considerations (initial franchise fee, royalties, other fees, discounts and rebates and the franchisor’s other income sources), onerous terms and franchisors’ attempts to pass maximum risk and responsibility for performance to their franchisees.

An alternative to this approach would have been to build more structured relationships, offering a framework through which the participants could better manage the impacts of VUCA.

Part 3 of this paper is dedicated to explaining why franchisors should consider franchise relational contracts for more strategic franchise relationships. We believe that, without a clear understanding of the why, franchisors may well resist and even openly reject relational contracting as a viable option. This section:

- Highlights the ***rise of the new economy***, which explains why franchisors must think more strategically about their relationships with their franchisees.
- Shows the real ***impact of value leakage*** in contracts. We share data about value leakage and provide real examples of how getting contracting wrong can cause long-lasting damage to an organization.
- Highlights ***weaknesses in franchise transactional contracts*** that point to the fact that a franchise transactional contracting model is often not appropriate for many of today’s more complex franchise relationships.
- Shares ***scientific research*** that supports relational contracting. We argue relational contracting is not just a good idea; the fundamental construct and theory supporting relational contracts is based on indisputable research, including several Nobel Prize-winning concepts.

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### The Rise of the New Economy

Most of the twentieth century was dominated by the *vertically integrated enterprise*, incorporating complex supply and distribution chains in one company or group of companies. Harvard Business School's Michael Porter literally wrote the manuals for creating a competitive strategy in a vertically integrated enterprise in his best-selling books *Competitive Strategy*<sup>14</sup> and *Competitive Advantage*.<sup>15</sup> For Porter, the enterprise was a combat unit on a battlefield forged by five market forces creating a threat of rivalry among existing firms, the threat of new entrants, the threat of substitute products or services, the bargaining power of buyers and the bargaining power of suppliers.<sup>16</sup>

Ironically Porter wrote the rule book at a time when vertically integrated organizations were already shifting to more decentralized and networked structures, including developing larger and better-organized franchise networks.

In the new economy, the combat unit is an organization's network, not the discrete organization entity itself.

Let's look at some of the key attributes of today's market:

- Today's market is more **global**. In the past, markets were smaller and more confined by national boundaries. Globalization has torn down these boundaries. While national market segmentations do still exist, the markets of today are generally geographically much more diverse than in the past.
- Today's markets are more **complex**. In the mass-market economy with large vertically integrated corporations as the main players, demand was easier to predict. Today, *the customer* no longer exists; rather the economy includes a multitude of customers with different tastes that change in unpredictable ways. Entire companies have made businesses out of serving the long tail of customer demand.<sup>17</sup>
- Today's markets are **faster**. The speed of the market, and market changes, is astonishing. New products and services can become obsolete in a matter of months. While innovation has always been important, innovation is now an imperative, requiring that organizations be flexible and responsive to change.

To summarize, markets are more global, more complex and faster; successful organizations rely on networks of more strategic commercial relationships to navigate in the new economy. This demands new levels of clarity, communication, collaboration and control, which is best answered through relational contracting.

### Value Leakage in the New Economy

A networked enterprise (like a franchisor) can only exist because of contracts between the entities in the network (i.e., the franchisor and its franchisees). It is therefore troublesome there seems to be a significant *value leakage* in contractual relationships in the market





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today. IACCM research has shown that poor contracting costs the average organization the equivalent of 9.15% of its annual revenue.<sup>18</sup> Value leakage takes the form of increased costs, missed savings and lost revenues. The IACCM data does not even attempt to put a price on missed opportunities, the impact of non-renewals and the costs of disputes or litigation.

But among all the stories of failures, there is a steadily growing number of individual success stories. IACCM research confirms that organizations that make investments in enabling better relationships cut the percentage of value leakage dramatically, to around 3.5%.<sup>19</sup> So why is it that the stories of success are not more common? Why do organizations struggle to replicate these productive relationships? One answer is that the networked business world has not as yet driven networked behavior. Trading partners (including franchisees) are typically viewed with some level of suspicion and an assumption they are driven by selfish instincts.

To make matters worse, many organizations use performance metrics that often encourage short term thinking and promote opportunistic, negative behaviors. While management may talk increasingly about issues of honesty and integrity, they often do little to shift motivation from short term opportunistic behavior – in part because they lack insight into the costs associated with transactional contracting behaviors or understanding of the alternative.

### **The Characteristics and Weaknesses of the Transactional Contract**

Another important and closely related reason for the relatively small number of success stories is the nature of transactional contracts themselves. In Part 1 (Exhibit 1), we used five characteristics to describe the transactional contract. Let's look closely at those characteristics and we will see why a transactional contract is increasingly not fit for purpose in today's economy. A quick review of the characteristics and weaknesses of the transactional contract explains much of the value leakage and failures from contractual relationships in the market.

#### ***Focus on the 'Deal' Not the 'Relationship'***

The focus of traditional contracting tends to be 'this deal', 'this time' and under 'this set of business and legal terms'. Negotiators and lawyers think, "Get a signature, and you are done." and "It is a done deal, and the deal is the deal."

A transactional contract definitely follows this logic. Let's look at a typical press release for a big 'deal.' The parties project success at signing, saying that company x has contracted with company y in a seven-year contract worth z million dollars. This assumes the parties know, at the date of the press release, all the transactions that will be carried out. A complex future is viewed as one big deal.



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As explained previously, today's dynamic business environment often makes it impossible to publish such a press release with a realistic claim for accuracy. In franchising, as in all other complex long-term business relationships, the parties know that in reality, the 'deal' will inevitably have to change over time because of changing demand, market circumstances, technologies, competitors, new products or services, improvements, etc. Well crafted, transactional contracts deal with this through clauses which most often involve either the approval of a large majority of the franchisees or the negotiation and signing of amendment agreements (as a party to a written agreement cannot unilaterally modify it during its term). But as most contract managers know, post-signing contract negotiations can be tedious and costly exercises, often involving intense discussions whether the change request should lead, or not, to additional compensation or concessions on other issues, and, if yes, how much or how many.

Those exercises generate transaction costs for which there can be only one name: waste. The cause of this waste is not the intent of the contract clauses. Rather, the problem lies instead in the focus. The parties persist to focus on the deal at the time of signing, even though they know that some provisions of 'this deal' (but without knowing which ones) will inevitably become irrelevant or insufficient during the course of its term. Without a change of focus, this waste cannot be avoided.

### ***Arm's-Length Relationships***

A franchise transactional contract establishes an arm's length franchisor-franchisee relationship. It is generally designed to limit as much as legally feasible franchisor's commitments and to gain as much control as possible over the franchisee's behavior and actions.

In real life, conventional approaches for using one's power causes a dilemma for today's networked and hyper-competitive economy. Why? Power-based strategies do not work because franchisors are more and more dependent on their network of franchisees, customers, suppliers and business partners to succeed. Arm's length relationships simply are not enough for franchisors-franchisees relationships where there is a great deal of interdependency. Successful franchisors are abandoning the arm's length mentality, choosing instead to create highly collaborative strategic relationships with increased interdependence purpose-built to create a win-win competitive advantage with their strategic business partners.

Professor Jeffrey Dyer and Harbir Singh are pioneering research in this area. They coined the term *relational rents* to refer to the above-normal returns generated by two or more companies using each other's knowledge and resources in unique ways that cannot be copied by others.<sup>20</sup> In an arm's length relationship, nothing unique can be created. Relational rents can *only* be generated through investments in relationship-specific assets, substantial knowledge exchange and combining of complementary resources.

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Making the shift means today's contracts require far more thought and versatility in how the relationship is contractually structured and managed.

And above all, creating strategic relationships requires abandoning the ambition to keep all business relations at an arm's length's distance. You cannot both generate relational rents through increased pooling of information and resources, *and* remain detached and independent simultaneously. The transactional contract with its arm's length character will fail to enable your strategic relationship to blossom and create the desired competitive advantage.

### ***Disconnect from Social Norms***

"It's not personal, it's just business." This is the mentality of the transactional contract. This mentality also means it is acceptable to violate fundamental social norms in pursuing one's own interests. In fact, opportunistic behavior is not only allowed, but expected as part of the 'negotiation game'. Millions of books have been sold on how to play the game – including the best-selling books *The Negotiation Game*<sup>21</sup> and *Start with No.*<sup>22</sup> We are taught to justify going against the social norms of *reciprocity* and *equity* when you have power and can shift risk to the other party.

In reality, violating social norms often generates risk, instead of mitigating them. Why? It is safe to assume the other party (i.e., the franchisee) will try to create strategies to improve its position and promote its own interests. In fact, the rational approach is for business people to look for ways to protect themselves or to 'get even'. Unfortunately, protection often means a lack of openness and transparency, withholding data or information, and placing limits on communication. This mindset is not evil, but one of human nature based on *opportunism*. After all, if there is a conflict of interest and the risk is significant – it is rational to think that both franchisor and franchisee will try to act in accordance with their *own* interest, not taking the interests of the other party, nor the franchise network as a whole, into consideration.

Psychological research supports this 'tit-for-tat' behavior, showing that while humans are opportunistic, they have a strong sense of fairness or, in the terminology of behavioral economics, *bounded self-interest*.<sup>23</sup> Most people want to treat others fairly and also want to be treated fairly. However, this also means that people will punish unfair behavior, i.e., behavior in breach of social norms.<sup>24</sup>

The simple fact is that violating social norms makes the situation worse – not better. It prevents and distorts the conversations essential for a healthy franchise relationship. It limits areas of discovery and stifles the very ideas that should lie at the heart of any long term, productive franchise relationship. Violating social norms by one party simply leads to a reaction (often a negative and opportunistic one) by the other party. And this results in unnecessary transaction costs.

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Economists such as Oliver Williamson have shown how contractual, legal and social norms interact to guide the behavior of individuals and enterprises in all commercial relationships.<sup>25</sup> The findings are clear; in more complex commercial relationships (like franchising), inefficiencies and transaction costs are generated when contractual norms come into conflict with the social norms which always exist in commercial relationships to a larger or lesser extent.

We are convinced that much of the value leakage in contractual relations is caused because transactional contracts have a ‘disconnect’ from social norms. The more one-sided and power-based the contractual obligations, the more an individual is triggered by human nature with a strong sense of fairness to create a counter-reaction for them to level the playing field. This can create a tit-for-tat negative cycle that at a minimum creates significant friction and increased transaction costs. Left unchecked, it can lead to lawsuits such as the Dunkin Donuts example we profiled earlier.

Simply put, conventional transactional contracts create a disconnect from social norms which can easily result in negative opportunistic behaviors rather than preventing them.

### ***Risk Mitigation Through Market Power and State Power***

As the saying goes “franchisee beware.” We’ve been taught to do business at our own risk and not expect others to look out for us. It’s our own fault if we have not taken enough precautions to avoid being taken advantage of. Franchisors use contracts to mitigate any potential risk that might arise. Conventional wisdom teaches to use the franchisor’s power to shift risk to the franchisee. While the franchisee might initially accept the risks – it rarely does so willingly. The more the franchisor seeks to shift risk, the more the franchisee will seek creative strategies to mitigate its risk or shift the risk back to the franchisor.

In a transactional contract, there are two main mechanisms to deal with the risks of opportunistic behavior. The first one is market power, the second state power. In combination, they give the impression of doing a good job in risk management. In reality, neither power-based mechanism does a good job. Let’s explore why each fall short.

We’ll look at market power first. By *market power*, we simply mean the ability to impose onerous terms on the other party (i.e., the franchisee) and the power to end the relationship, with as few obligations as possible of your own. The power to end the relationship is most effectively ensured by many extensive, and somewhat discretionary, termination clauses in favor of the franchisor (and none, or only a few, in favor of the franchisee). Onerous terms may take many forms but generally relate to issues around ownership or control of important assets and consequences of default. Under classical legal theory, there is a strong belief in driving performance through purely negative incentives.



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Mitigating risk through market power has serious downsides – not least of which is that it rarely works. The costs (in time, money, resources and consequences, including the potential impact on the franchisor’s reputation, for example in traditional or social media, and on the quality of the relationship between the franchisor and its other franchisees) of terminating a franchise agreement or of losing a franchisee can be very high. Additionally, having such provisions often leads the franchisees to restrict their investment in the relationship. Consider, for example, whether a franchisee forced into a corner will willingly provide the franchisor invaluable information about its customers, its employees and its operations.

In situations like franchising with significant interdependency, using market power in forming the agreement will invariably undermine potential results.

What about *state power*? By state power, we mean the power to legally enforce contractual rights and obligations. Contractual rights and obligations backed up by state power appear to be a great tool for risk mitigation. After all, the entire idea of a contract is based on the assumption of a possibility for enforcement.

We argue that the state power mechanism for mitigating the risks of opportunism has serious downsides. Why? The court system is not 100% effective and a contract breach will not automatically lead to enforcement. In addition, it is very expensive (in terms of money, time and resources) to go to court. The court process can take many months or years during which the disputing parties have to continue collaborating before a final decision is reached and can be enforced. Also, court proceedings divert the attention of the franchisor’s executives and managers from their most important duties, which are to manage the franchise network. For these reasons, the vast majority of parties settle out of court to avoid these consequences, the astronomical legal bills and the potential damage to their reputation. IACCM research supports this assumption, showing that while 30% of negotiated contracts encounter a substantial disagreement between the parties at some point during their execution, only 0.007% end with litigation or arbitration.<sup>26</sup> Even though most contracts rely on an implicit assumption of the effectiveness of the court system, in reality, state power is hardly ever used as a viable option.

In summary, the risk-mitigating mechanisms of the transactional contract – market power and state power – create an illusion of safety when in reality they can be weak in managing known risk and largely ineffective in dealing with unknown or unanticipated risks.

### ***Complete Planning***

A contract is first and foremost an economic instrument with the purpose to support the realization of business plans. To develop a franchise network, to build a house or a railroad, to execute a marketing campaign, to ensure access to information technology all requires many activities from the parties in contracts. The goal of the contract is to ensure that the plans are realized. Conventionally this is done by allocating control over the

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activities through contractual obligations. For example, the franchisor would create, in the franchise agreement and its operation manual, a detailed prescriptive statement of the activities to be performed by each of its franchisees.

The problem is, again, a tendency for opportunism. What if the franchisor has missed something when making a plan? Will not the franchisees take advantage of the situation? Most likely yes, especially if the prior negotiation was focused on the financial considerations to be paid to the franchisor, the franchisee's obligations and duties and minimizing the franchisor's risk (by transferring most of it to the franchisee). But rather than recognizing these recurrent symptoms and learning from experience, many franchisors react by becoming even more demanding in their agreements. The result? The never-ending quest to make the contract more 'complete' so that the franchisee cannot 'take advantage' or 'try to equalize the risk and the reciprocal responsibilities' after the contract has been signed.

This approach views the franchise relationship in the context of battlegrounds and as a war of attrition. *To maintain control, the plan must be complete and written down in the signed contract.*

Complete planning is the attitude of the transactional, adversarial contract. But just as with risk mitigation and disconnection from social norms, achieving a complete plan in a complex environment is based upon a costly illusion. Indeed, 2016 Nobel Prize winner Oliver Hart has decisively shown that most contracts are incomplete. As we have written, today's business environment is complex, fast-moving and unpredictable. Supply and demand change quickly. Market threats come from all angles, ranging from new competitors, customer hypes, disrupting technology, regulation and unpredictable events such as hit the Corona Virus which disrupted the business world beginning in 2019. Essentially, we are dealing with a growing volume of the unknown or the unknowable. Relationships must be designed, not to eliminate these realities, but to cope with them. The transactional contract has no mechanisms for achieving the much needed flexibly and collaboration demanded by today's environment.

The fact is complete planning becomes harder and harder in the new economy. An irony about complete planning is that psychological research has revealed that we never were good planners to start with.<sup>27</sup> To borrow terminology from behavioral economics, we suffer from *bounded rationality* because we don't have enough time to gather all information and that our brains cannot deal with all of the information. The conclusion? It has always been impossible for a transactional contract to live up to the ambition of complete planning.

### Research Supporting Relational Contracts

While the previous sections showed scientific support for the disadvantages of franchise transactional contracts, this part of the paper shares the advantages and benefits of the franchise relational contract. We show relational contracting has the strong support of

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Nobel Prize-winning research in psychological, economic and social theory. As an example, in October 2016, the work of Professors Hart and Holmstrom was recognized when the Nobel Prize for Economics was awarded. Their research highlights the importance of contracts being 'properly designed to ensure that the parties take mutually beneficial decisions'—a philosophy that lies at the heart of relational contracts.<sup>28</sup>

A key reason relational contracts make sense is that contracts are negotiated, written hand entered into by humans. This means that the logic of human psychology, as it has been formed by evolution, has a strong influence on the practice of contracting. But not only psychology plays a role; humans entering into a contract are acting within economic and social systems that together form the rules of the game of contracting, leading to either beneficial or non-beneficial economic results. Therefore, economic and social science also teaches us important lessons about contracting.

While there are literally hundreds of research studies supporting the concepts and logic behind relational contracting, in this paper, we limit ourselves primarily to the psychological research.

Contracting is about planning for future exchanges of goods and services for money, and about how to deal with the risks and opportunities entailed to such exchanges. It is because the future is unknown and because we as humans have a tendency to act opportunistically that contracts are needed in the first place. As we have repeatedly said, contracts are written to deal with the future.

The problem is that we are psychologically ill-equipped to deal with the future. As far back as 1957, Nobel Prize winner Herbert Simon concluded that humans are rational, but only to a limited extent.<sup>29</sup> There is probably no one that has investigated deeper the limits of our rationality than Professor Daniel Kahneman, 2002 Nobel Prize winner and author of the best seller *Thinking, Fast and Slow*.<sup>30</sup> We draw several important conclusions from Kahneman's work and the work of the psychological branch of economics – behavioral economics. We focus on three key concepts:

1. The systematic errors we make because of our bounded rationality
2. Our limited ability to correctly assess risks
3. Our sense of fairness

### **1. The Systematic Errors We Make as a Result of Our Bounded Rationality**

Instead of being omnipotent, all-knowing and rational creatures (which is the assumption of traditional economic theory), we use rules of thumb and simplified models of the world to get around. These rules of thumb are called *heuristics*. Since they are simplifications, they are not necessarily correct, meaning they can lead to systematic biases or fallacies. From the perspective of contracting, the most important one is the *planning fallacy*, already mentioned in the introduction. Our bounded rationality severely limits our ability to plan for





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the future, which is a key component in all contracting. However, our mind also tricks us into thinking we are good at planning for the future. Simply put, we suffer from *overconfidence*.

The planning fallacy and related biases mean that, in the complex, fast and global economy, *we will with absolute certainty fail if we try to deal with the uncertainty of the future through a transactional contract*. Instead, relational contracts could be used, containing mechanisms for transparently sharing information and feedback loops allowing the parties to adjust the contract as the future unfolds while keeping interests aligned.

### **2. Our Limited Ability to Correctly Assess Risks**

Our limited rationality also means we are poor in assessing risks, another key activity in contracting. The planning fallacy means we most likely will fail to identify commercial and contractual risks. And even if we identify a risk, we rely on feelings when assessing it, instead of a rational analysis of likelihood and negative impact. The less we like a possible future event, the riskier it appears to us. Professor Cass Sunstein has coined the term *probability neglect* for the tendency—all too common among lawyers—to overemphasize the potential negative outcomes of an event, paying little or no attention to whether this outcome is likely to occur.<sup>31</sup>

Since the future has never been more uncertain, it has also never been riskier. We are not psychologically equipped to deal with such risks through the transactional contract, in which all risks must be addressed at the moment of signing. Instead, the relational contract could be used, including governance mechanisms for continuous and collaborative risk management, allowing the parties to, over time, keep the risks of their partnership at acceptable levels.

### **3. Our Sense of Fairness**

Daniel Kahneman and Richard Thaler, one of the founding fathers of behavioral economics, have also demonstrated our strong sense of fairness.<sup>32</sup> This sense of fairness has a positive and a negative side, both relating to our feeling for reciprocity. On the positive side, we have a natural tendency to act with fairness. On the negative side, it means we are willing to punish those who treat us unfairly, even if it is to our own economic disadvantage or against our long-term interest.

The positive and negative side of our sense of fairness has been proven beyond doubt in experiments such as the Ultimatum Game. In this game, individual A – the proposer – is given a sum of money and is requested to suggest to individual B – the responder – how the money shall be shared between them. If the responder accepts, the money is split per the proposal. If the responder rejects the offer, neither party gets anything.





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Against strict economic reason, the proposers typically offer 50/50 splits instead of offering as little as possible, showing the positive side of our sense of fairness. On the other hand, the responders typically reject offers of 70/30 splits or less, even if they would be better off with, say, 10% of the money than nothing. The responders are thus willing to punish unfair behavior, even against their own self-interest.

Contracting is not only about planning for the future. It is also about dealing with opportunistic behavior. Here, the transactional contract suffers from a severe blind spot – a power-based contract disconnected from social norms. But as the Ultimatum Game shows, we don't respond well to use or abuse of power. Power-based processes and practices of the transactional contract often trigger opportunistic behavior. And we try to deal with opportunism through the threat of market or state power.

Simply put, we respond to power with power, to unfairness with unfairness.

### **The Need: Continual Alignment of Interests**

Psychology and behavioral economics prove that (i) we are psychologically ill-equipped to succeed with the completeness ambition of the transactional contract, (ii) our limited ability to correctly assess risks grants an illusion of safety to the transactional contract, and (iii) the contracting and negotiation processes we typically use often generate opportunistic behavior instead of protecting against it. While we have offered three clear reasons to shift away from transactional contracts, these same three reasons also offer a compelling reason to shift toward relational contracts – especially when operating in a complex, fast-paced or uncertain business environment.

For more strategic contracts with higher risks and uncertainty, what is needed is a relational contract that seeks to continually advance interests in the face of uncertainty. The relational contract—and equally important the process to enter into it—will bring out the positive side of our sense of fairness and help us best deal with these uncertainties in a much more constructive manner.

But how do you create a franchise relational contract? Read on to Part 4.



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## **PART 4: HOW TO CREATE A FRANCHISE RELATIONAL CONTRACT**

In Part 3, we illustrated the severe weaknesses and sometimes even the dangers of using a franchise transactional contract in a complex and uncertain environment. We also shared the logic for shifting to a franchise relational contract. The purpose of Part 4 is to help you understand *how* to develop a franchise relational contract.

A key goal of a franchise relational contract is to create a continuous alignment of interests throughout the contract term. As outlined in Part 2, there are five essential focus areas for developing a relational contract. Each of these focus areas aligns with a proven five-step process designed to help organizations make the shift from traditional transactional contracts to highly collaborative relational contracts. The five-step methodology was profiled in the Harvard Business Review article – *A New Approach to Contracts: How to Build Better Long-Term Strategic Partnerships*.<sup>33</sup> The following section expands on the five steps and shows how franchisors and franchisees can make the shift:

1. **Lay the Foundation for the Partnership.** This step explores and lays the foundation of trust, transparency and compatibility between the franchisor and its franchisees to lay the foundation for a successful strategic partnership between them.
2. **Align on a Shared Vision and Objectives.** The second step builds on Step 1 by the establishment of the franchise network’s vision, values and objectives for the franchisor-franchisees strategic partnership, specifying what joint success and value look like.
3. **Adopt Guiding Principles for the Relationship.** In Step 3, the franchisor (with its existing franchisees if it has then any) formally establishes the guiding principles (social norms) for the franchise network. These guiding principles – coupled with mutually agreed shared vision and objectives – becomes the heart of the relational contract with its franchisees.
4. **Align Expectations and Interests.** Step 4 is where the parties address the specific obligations of the franchisor and of the franchisees. In this step, the parties ensure the financial arrangement and contractual clauses support the achievement of this vision and these objectives.
5. **Stay Aligned.** Steps 1 through 4 enable the parties to create the “guts” of the relational contract. However, this is not enough. It is also essential for the relational contract to establish a robust governance framework for continuous relationship management. In this step, the parties determine the more specific “rules of the relationship” and how their governance structure will keep the franchisor and franchisees aligned as they seek to evolve and change with the dynamic nature of business.

We go into each of the five steps in this section of the paper.

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**Step 1: Laying the Foundation for the Partnership**

The first step of creating a relational contract is to lay the foundation for the partnership. This step helps you make the shift with the first characteristic of the relational contract to focus on the commercial relationship instead of simply the commercial transaction – or “deal”.

	<b>Transactional Contract</b>	<b>Relational Contract</b>
<b>Focus</b>	The commercial transaction	The relationship
<b>Relationship</b>	Arm's-length relationship	Partnership
<b>Social norms</b>	Disconnect from social norms	Explicitly includes social norms as contractual obligations
<b>Risk management</b>	Use of power and creation of enforceable contractual obligations	Risk avoidance by creation of continuous alignment of interests
<b>Planning</b>	Aims for complete planning, i.e., contract should cover all future events	Creates a fair and balanced flexible framework

It is common practice for a lawyer or an advisor to say, “I am working on closing the X transaction” or, “I am negotiating the Y deal.” As we have seen, a transactional contract puts the focus on the deal, viewing all the future transactions as one big deal. In a relational contract, the focus is put on the relationship, with the ‘deal’ simply being a component of the overarching relationship.

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### ***What Does It Mean?***

Let's look at what it means to focus on the relationship and not the deal by picking out a classic from the library. Thought leader Jim Collins provides an excellent analogy of what it means to have a long-term view versus a short-term view in his book *Built to Last*<sup>34</sup> (co-written with Jerry Porras). The book provides a telling comparison between successful and less successful companies by using the terms 'clock builders' and 'time tellers.'<sup>35</sup> Some companies succeed because they have amazing products and services, but their success fades when those products and services fade in popularity. Those companies are time tellers. Other companies have successful products and services because they are created by amazing companies, clock builders, who will generate profits year after year by always producing new products and services that the market wants. In the race of the market, it is always the clock builders that win in the long run.

The comparison of time tellers and clock builders can be used to compare transactional and relational contracts. In transactional contracting, the focus is on telling the time, on the deal. When the exchanges planned for in the deal have been carried out, the relationship terminates and no more value is created. In relational contracting, instead, the focus is on building a clock, i.e., a relationship that can continue to generate value when all the transactions of the initial deal have been carried out. This means the parties must begin discussions with a potential partner that send signals about the importance of the partnership, and not the importance of the deal.

### ***How Do You Do It?***

Focusing on the relationship instead of the deal has important consequences for both the contracting process and the actual contract content.

First, a franchisor must seek to create trust. Much has been written on building and sustaining trust in a relationship.<sup>36</sup> Trust is generated when there is alignment between words and actions, i.e. when you can feel a confidence that what someone is saying will also be followed by its actions. You can trust a person that shows integrity in this sense.

But how do you build trust, especially at the start of a new relationship? Trust must be consciously built – and the relational contract is a fundamental building block. *Trust* must be combined with a high degree of *transparency* and *compatibility*.<sup>37</sup> Why? Given our limited abilities for planning, high transparency from both parties will be critical. The franchisor and its franchisees will all need as many facts on the table as possible to be able to cope with the future in a changing market. But even if trust and transparency levels are high, differences in organizational cultures could lead to friction and problems to make the relationship work. Compatibility is not absolutely necessary, but at the least highly important. Using the process, we have outlined enables the franchisor and any potential franchisee to sit down, first by themselves and then together, and ask some serious and



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sometimes also uncomfortable questions: Are we trustworthy? Do we align our actions with what we say?

1. Are we prepared to work collaboratively and in good faith with our potential franchisee/franchisor, or do we feel we may have to use power to induce him/her to do as we want?
2. Is there evidence we both share the same values (i.e., those of the franchise network) and readiness to operate under the franchise network's vision, mission, values, principles and objectives?
3. Are we both prepared to be transparent, i.e., to share information about our plans for the future, our internal challenges, our risk register, our costs and even margins?
4. Are we compatible? Do we share a base of organizational value, interests and views of the world and of the franchisor-franchisees relationship? Is this alignment likely to continue?
5. Do we have evidence to support our answers, or are we just hoping?

By using this process, the parties lay the foundation for implementing a spirit of joint working and communication, which is critical for the success of governance of any franchise network.

**Action:** Find out if you are ready to become strategic partner with each potential franchisee and, vice-versa, if each such potential franchisee is ready to become strategic partner with you and your franchise network, by understanding your respective initial levels of trust, transparency and compatibility.

Once you have ensured you have laid a strong foundation, you can then create a strong 'society of principles' by embedding social norms in the relationship, as explained next.

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**Step 2: Align on a Shared Vision and Objectives**

The second step of creating a relational contract is to align on formal shared vision and objectives for the partnership. This step helps the contracting parties promote a “partnership” versus an arms-length relationship because they are working toward common goals and objectives.

	<b>Transactional Contract</b>	<b>Relational Contract</b>
<b>Focus</b>	The commercial transaction	The relationship
<b>Relationship</b>	Arm's-length relationship	Partnership
<b>Social norms</b>	Disconnect from social norms	Explicitly includes social norms as contractual obligations
<b>Risk management</b>	Use of power and creation of enforceable contractual obligations	Risk avoidance by creation of continuous alignment of interests
<b>Planning</b>	Aims for complete planning, i.e., contract should cover all future events	Creates a fair and balanced flexible framework

***What Does It Mean?***

Misaligned interests are the most common cause of value leakage and unnecessary transaction costs. The source of misaligned interests is *conflicting goals and objectives*. If a franchisor’s goals and objectives can be achieved only at the cost of the franchisees’ achieving their goals and their objectives, interests will be misaligned and opportunism and friction will follow as a necessary consequence. For example, an important source of value leakage is that franchisees’ goal of lowering their costs comes into conflict with the franchisor’s goals of increasing its revenue and margin. This is not a goal or conflict given by nature, but instead, a result of conventional economic models most often used in most franchise relationships today.

Unfortunately, the conventional franchise transactional contract establishes an arm’s length relationship which seeks to draw clear boundaries between the franchisor and the franchisee. A franchise relational contract establishes a different kind of relationship, a *partnership per se*. We have hesitated to use the term ‘partnership’ in this paper for two reasons. First, it is an often-abused concept by business professionals. One franchisee said, “When my franchisor tells me it wants me to be more of a partner, it is typically followed with the expectation for me to open up my checkbook.” Second, lawyers in some jurisdictions eschew the term due to the legal definition of a partnership (e.g., a partnership creates a legal entity such as a joint venture).



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But we have purposely chosen to use the word partnership to describe a franchise relational contract because there simply is no other term that better describes what characterizes the relationship established through a relational contract. While a relational contract does not create a 'legal' partnership, it does create the spirit of a relationship that embodies the spirit of a partnership.

A franchise relational contract – by design – seeks to align interests by avoiding goal conflicts between the franchisor and its franchisees. This is done through alignment on a shared vision and common objectives. Joint – not separate - goals and objectives should be adopted.

### ***How Do You Do It?***

To adopt a shared vision and strategic objectives is to adopt a common view of what is valuable. For example, what specific goals and objectives that, when achieved, generate revenues or improves productivity for both the franchisor and its franchisees? A good franchise network vision should not be too long, paint a successful common future, and be aligned to the franchisor's business strategies. You know you have a good franchise network's vision when the franchisor and each of its franchisees embrace it with enthusiasm, feel engaged and want to roll up their sleeves immediately to achieve it.

Co-creating a shared vision and common objectives is a powerful exercise and, when the franchise network already has existing franchisees, should preferably be done jointly. When this is done jointly - the franchise network's interests are tied to what the franchisor and its franchisees together perceive as valuable.

**Action:** Create a franchise network's vision and formalize it in writing.

When you have created a franchise network's vision, it is often a good idea to break it down into more tangible strategic objectives for the franchise network, which specifies in more detail what the franchise network's vision means. The objectives range is based on the intent of the franchisor for its franchise network. Objectives typically fall into one of three categories:<sup>38</sup>

- Outcome-based – which are boundary-spanning objectives that typically can be achieved only with a high degree of collaboration (e.g., a franchisor cannot achieve great notoriety without its franchisees)
- Output-based – which are typically tied to a specific scope of a one or both parties (e.g., customers' service in a franchised establishment)



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- Transaction-based – which are typically linked to the effectiveness of a specific task or activity (e.g., the implementation of an online sales site)

While any of the above categories is acceptable, we argue the most effective relationships use outcome-based objectives which promote a high degree of collaboration to achieve boundary spanning win-win business objectives. We also argue to use at a maximum of 4-6 objectives – otherwise the parties will lose focus in governing the relationship.

**Action:** Break down the franchise network’s vision into strategic objectives.

### Step 3: Adopt Guiding Principles for the Partnership

The third step of creating a relational contract is to adopt guiding principles (social norms) for the partnership. In doing so – the franchisor and franchisee formally embed proven and powerful social norms into their relationship.

	← Transactional Contract	Relational Contract →
<b>Focus</b>	The commercial transaction	The relationship
<b>Relationship</b>	Arm's-length relationship	Partnership
<b>Social norms</b>	Disconnect from social norms	Explicitly includes social norms as contractual obligations
<b>Risk management</b>	Use of power and creation of enforceable contractual obligations	Risk avoidance by creation of continuous alignment of interests
<b>Planning</b>	Aims for complete planning, i.e., contract should cover all future events	Creates a fair and balanced flexible framework

To understand why it is important to embed social norms into a relational contract let’s turn to legal scholar Ronald Dworkin. Dworkin established a clear distinction between what he calls a “rulebook community” and a “society of principles.”<sup>39</sup> While the distinction is aimed at societal relationships rather than contractual relationships, it is nevertheless highly useful.

According to Dworkin, a “rulebook community” is a community that “...accepts a general commitment to obey rules established in a certain way in that community. Imagine self-interested but wholly honest people who are competitors in a game with fixed rules or who are parties to a limited and transient commercial arrangement. They obey the rules they have accepted or negotiated as a matter

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of obligation and not merely strategy, but they assume that the content of these rules exhausts their obligations.”<sup>40</sup>

This description of a rulebook community clearly fits the kind of relationship established by a traditional, transactional contract. The attitude is that the parties have clear and written obligations, but hold no commitment to each other besides what is in the contract. When the contract is silent, no one else will speak.

This should be contrasted with Dworkin’s description of a society of principles, which fits the kind of relationship established through a relational contract. The parties to a society of principles accept

“...that they are governed by common principles, not just by rules hammered out in /.../ compromise. /.../ Members of a society of principles accept that their /.../ rights and duties are not exhausted by the particular decisions their /.../ institutions have reached, but depend, more generally, on the scheme of principles those decisions presuppose and endorse.”<sup>41</sup>

In a society of principles, a partnership exists in which “each partner is concerned not just to keep explicit agreements hammered out at arm’s length but to approach each issue that arises in their joint commercial life in a manner reflecting special concern for his partner as a partner.”<sup>42</sup>

In a franchise transactional contract, the boundaries are kept strictly separate from rights and obligations and do not extend beyond the written clauses, whereas the franchise relational contract creates more of a ‘virtual entity’ based on certain underlying principles. A key difference is that a franchise relational contract also establishes the mechanisms through which principle-based behaviors (e.g., social norms) will be enabled and rewarded.

To understand the social norms, it is often easier to think about how they apply in society in general versus in a commercial agreement. In society, people have moral obligations toward each other. These moral obligations impact behaviors, feelings and actions. Take the norm of *honesty*. If we lie to you and you find out, we will feel ashamed – a symptom of the breach of a social norm. You may avoid us, creating a pattern of passive-aggressive behaviors and actions.

Or take for instance the norm of *reciprocity*, which creates an obligation to return in kind. If we invite you to dinner, you will feel obliged to reciprocate and invite us for dinner or do us some other thoughtful gesture (bring flowers and wine or offer to take us sailing on your boat). If you don’t reciprocate, you most likely will feel ashamed. We may blow off your actions as forgetfulness. But over time if you do not reciprocate, we will quit investing in the relationship and stop inviting you to dinner because we will not feel our actions are valued.

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Social norms are not just a nice thing to say or to write about. Social science has proven a clear tie between social norms and the effectiveness of a society or a group of individuals.<sup>43</sup> Simply put, the more a society adopts positive social norms the more trusting and productive the society.

But can (or should) basic social norms be embedded in contracts? The answer is yes. In fact, to convert social norms into contractual norms is one of the most critical steps of the franchise relational contracting process, dispelling any idea that relational contracting is something soft and should only be used outside the courtroom. If social science has unequivocally linked the success of societies to adherence to the social norms among individuals and groups of individuals, why wouldn't you want to embed the social norms contractually in a franchise relationship?

Embedding social norms into the foundation of the contract is where the informal relational contract discovered and explored by such researchers as Macaulay and Macneil, mentioned in the introduction, is transformed into the formal, modern form of relational contract needed in the new economy.

### ***What Does It Mean?***

A relational contract establishes a 'society of principles' when the parties contractually agree to adopt a set of social norms or *guiding principles for the partnership*. These six guiding principles should be adopted:<sup>44</sup>

1. The principle of **reciprocity** – the principle obliges the parties to *return in kind*; if you take a risk, you should be compensated appropriately.
2. The principle of **autonomy** – the principle obliges the parties to *abstain from using power (save when needed in the interest of the franchise network)*, allowing each party to make autonomous decisions, independent of undue influence from one another.
3. The principle of **honesty** – the principle obliges the parties to tell the truth about facts and their intentions.
4. The principle of **loyalty** – the principle obliges the parties to look out for each other's and, more important, for the franchise network's *interests* and treat each other's interests with equal value.
5. The principle of **equity** – the principle obliges the parties to act fairly in the execution of the contract.
6. The principle of **integrity** – the principle obliges the parties to be consistent over time, i.e., to treat like cases and to avoid opportunistic behavior but to always, when in doubt, act in accordance with the other guiding principles.

Why do we list those six guiding principles and not others? There are several answers to this question. First, think of what would happen if you try to establish a strategic franchise partnership and take those principles away. Would a strategic franchise partnership

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without honesty and loyalty survive for long? A strategic franchise relationship without fairness would soon deteriorate, as would a strategic franchise relationship that, in breach of the integrity principle, is not consistent over time in applying the other principles.

Second, each of the six guiding principles are based on scientific research in psychological, social and economic theory. As we have said above, research has clearly proven a link these principles are not only important, but also that societies and groups that adhere to these norms outperform those where the principles are missing.

Third, it should be noted, the six guiding principles listed above are not necessarily an exhaustive list of all known social norms. Contracting parties may add any other social norms or guiding principles they think are relevant. For example, some relational contracts have added a guiding principle of **transparency**. Adding this principle obliges the franchisor and its franchisees to transparently and reciprocally share information on the basis that it is critical to the success of the franchise network. Or take McDonald's (which is discussed in much more detail in Part 5) which embeds a '**System First**' principle obliging the franchisor, franchisees and key strategic suppliers to make decisions and act firstly in the best interest of the franchise network as a whole.<sup>45</sup>

The guiding principles fulfill at least four important functions in the relational contract:

1. They will guide the parties during any negotiations throughout the whole duration of their relationship. The only valid arguments in the discussions are those that can be justified under one or more of the guiding principles.
2. All the franchise contract clauses shall be aligned to the principles. This will to a maximum extent ensure that the contract is fair, balanced and facilitate the creation of a frictionless relationship.
3. The guiding principles shall, with the franchise network's vision, constitute the basis for interpreting the franchise agreement, both when the written clauses are ambiguous and when the contract is silent on a particular matter. We will deal with this further in the next section.
4. The guiding principles will also assist the parties when updating the contract to address changing business priorities or regulatory requirements.

Not only will the guiding principles ensure a fair and balanced franchise agreement, but they will also ensure that the contract remains mutually beneficial throughout its term. When dealing with change the parties must find solutions sanctioned by the principles of loyalty and equity. Any solution not in the best interest of the franchise network or that is not equitable will be in breach of these principles. As we will see in the next section, the guiding principles are therefore also a key instrument for preventing opportunistic behavior from the franchisor or from any franchisee.



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By embedding the guiding principles in the relationship, the parties also lay the foundation for more equitable risk allocation and fairness of economics such as using pain and gain sharing mechanisms.

Will the guiding principles create a fail-safe system?

Of course not. But they will create a franchise network in a much better position to create and keep interests aligned than the franchise transactional contracts, which only deals with conflicts of interests as a fact that cannot be avoided.

### ***How Do You Do It?***

To a greater or lesser extent, the guiding principles exist in most relationships. However, because they rarely are stated and openly discussed, we are often unaware of the presence of the principles as social norms in our relationships. In many cases, we deliberately (or subconsciously) ignore them in search of short-term advantages (e.g., 'shading' in the words of Nobel Prize-winning economist Oliver Hart). The first step when adopting the guiding principles is therefore to have an open and candid discussion and define each of the guiding principles. We think of this as 'discovering' each principle. As social norms, they exist between the parties before the discussions start, so they are not invented. For most, it will be the first time the parties (or even individuals) have ever openly discussed how to apply social norms in a business context – let alone a contract.

The guiding principles are best codified as part of a Statement of Intent (sometimes called a 'Charter') to the relational contract. The authors recommend coupling the shared vision/objectives with the guiding principles into a formal one or two-page Statement of Intent or 'Charter' that represents the parties' mutual desires for the relationship. Some franchisors may put this in the main body of the franchise contract while others may prefer to create a Schedule or a stand-alone document to codify their intentions of how the parties will behave over the life of their relationship. Our strong preference is to embed the Statement of Intent or Charter into the actual formal contract. In Appendix 1, we have included an example of how the guiding principles can be documented in a franchise contract.

**Action:** The franchisor (jointly with its existing franchisees if it has then any) should 'discover' and together define the franchise network's guiding principles and formalize them in writing as part of their agreements.

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**Step 4: Align Expectation and Interests**

The fourth step of the relational contracting process is where the parties begin to draft the specific obligations for the relationship. In essence – agreeing on the “guts” on the contract regarding legal obligations and commercial aspects of the agreement. In doing so, contracting parties align on mechanisms that will help the parties address risks so it optimizes risk mitigation rather than simply shifting risk.

	<b>Transactional Contract</b>	<b>Relational Contract</b>
<b>Focus</b>	The commercial transaction	The relationship
<b>Relationship</b>	Arm's-length relationship	Partnership
<b>Social norms</b>	Disconnect from social norms	Explicitly includes social norms as contractual obligations
<b>Risk management</b>	Use of power and creation of enforceable contractual obligations	Risk avoidance by creation of continuous alignment of interests
<b>Planning</b>	Aims for complete planning, i.e., contract should cover all future events	Creates a fair and balanced flexible framework

When determining the rights and obligations of each party, those rights and obligations must all be aligned with and be justifiable under the franchise network’s guiding principles.

***What Does It Mean?***

Step 4 is determining ‘the deal’ and the risks related to it and the franchise relationship. The franchisor, jointly with its existing franchisees if there are then any, need to determine the main provisions of the franchise contract, including, among many others, the contract duration, payment amounts and terms, franchisor’s and franchisee’s respective roles, rights and obligations, confidentiality, non-competition, rules for terminating the contract, what should happen if breaches occur, what limits should be set to the parties’ liabilities, protection of intellectual property, etc.

We highly recommend using a flexible contract framework versus trying to capture every level of detail. The clauses you adopt in the franchise contract will play a role in interpreting the contract. But the contract language, together with what you decide not to write in detail in the franchise agreement, will also play an important role in providing the necessary



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flexibility you need to manage change in a dynamic business environment. The key is finding the right balance.

The guiding principles play a vital role in developing and interpreting the contractual clauses and language. First, the parties must ensure that all the written clauses are aligned to the guiding principles from the start. Second, the guiding principles provide a way of interpreting the clauses (and lack of contract language).

A quick look at a typical franchise transactional contract shows that many of the typical clauses are in breach of the guiding principles. Some examples are:

- Non-reciprocal and non-equitable indemnification rights or limitations of liability.
- Sweeper clauses obliging the franchisee to supply goods or provide services without a right to compensation in accordance with the equity principle.
- Termination clauses giving the franchisor somewhat discretionary rights to end the relationship.
- Limitation of liability clauses that fail to keep the risks for the relationship as a whole as low as possible.

To be clear, clauses about indemnification, limitation of liability, termination, etc. are not as such in breach of the guiding principles. But in conventional franchise transactional contracts, they are often written in breach of those principles. In a franchise relational contract, they can and should be used. But the intent and wording must be fair and balanced, aligning to the guiding principles.

Think about this: what would it mean to make all the clauses of the franchise contract aligned to the guiding principles? Take, as an example, termination clauses giving the franchisor somewhat discretionary power to end the relationship? Could such a clause be compatible with the guiding principles? That seems a challenge, especially since this kind of clause is a classic power instrument used by many franchisors. But what if the reciprocity principle is used, making the termination right mutual? That would create more of a power balance between the parties.

It is important to understand that there is seldom one 'right' answer or solution when it comes to clauses such as the ones discussed above. An unfair indemnification clause in one contract could be compatible with the guiding principles in another. This is partly because it is necessary to always look at the total risk allocation in the franchise contract when assessing its overall fairness. It is also because the *process* of agreeing on a particular clause – with honesty, reciprocity and autonomy – is as important for a clause's fairness as its actual *content* or the result of the process.



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### *How Do You Do It?*

The challenge? How exactly do you write contract clauses that are fair and balanced and align with the intent of the partnership – including the guiding principles?

Think about this: what would it mean to make the written obligations and legal clauses of the contract aligned to the guiding principles? The answer to this question will be different depending on whether a transactional or relational view is taken. Once you answer this question, it becomes easier to recast common contract clauses into relational contracting clauses.

**Action:** Review your existing contract. Which clauses (if any) are not in alignment with the guiding principles? Consider recasting these clauses to be fairer and more balanced.

Once you have updated your obligations and contract terms, it is important to remember that no matter how hard you try to write the perfect contract, changes in the market occur and priorities shift. Your franchise contract will be full of cracks and holes with risks and events not dealt with in the contract clauses. When this happens go back to your franchise network's vision and guiding principles. Why? The franchise network's vision and guiding principles fulfill an important role in dealing with the tricky combination of arising conflicts of interest in an incomplete contract. This is done by agreeing on how the franchise contract shall be interpreted when something is ambiguous or even silent in the contract.

A well-crafted contract interpretation clause helps the parties make necessary changes in the relationship and contract in the light of the franchise network's vision and guiding principles. Specifically, the parties should agree that the franchise network's guiding principles and vision shall, so to say, fill in the blanks when the contract is silent on which rights and obligations the parties have in a particular situation. For some, this may seem a controversial move to make. To say that the franchise network's guiding principles and vision shall apply when the contract is silent means to add obligations where the contractual language in the contract is silent or uncertain. For contract lawyers used to reliance on an 'Entire Agreement' clause where the goal is to ensure contract obligations are exhausted by the written word, this will seem risky. This perception is, however, based on the incorrect franchise transactional contract assumptions that contracts can and should be complete. As we have seen, this is an illusion. All complex contracts are incomplete and unless the cracks and holes are dealt with through the franchise network's guiding principles and vision, opportunism will enter and value will erode. To ensure that the contract is interpreted in the light of the franchise network's guiding principles and vision therefore *decreases* the risk of the relationship significantly.

**Action:** Review your existing contract interpretation clause(s). Use Appendix 2 as inspiration for how to rethink your contract interpretation clause.

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**Step 5: Stay Aligned**

The last step in the relational contracting process is for the franchisor and its franchisees to agree on a governance framework. In doing so, they make the shift toward two of the key relational contracting characteristics which enable the parties to stay in continual alignment well after the contract is signed.

	<b>Transactional Contract</b>	<b>Relational Contract</b>
<b>Focus</b>	The commercial transaction	The relationship
<b>Relationship</b>	Arm's-length relationship	Partnership
<b>Social norms</b>	Disconnect from social norms	Explicitly includes social norms as contractual obligations
<b>Risk management</b>	Use of power and creation of enforceable contractual obligations	Risk avoidance by creation of continuous alignment of interests
<b>Planning</b>	Aims for complete planning, i.e., contract should cover all future events	Creates a fair and balanced flexible framework

As we have discussed, a transactional contract tries to be complete in the sense there should be no future events that the contract cannot deal with. The theory and practice is that transactional contracts should never be silent, no matter what happens.

Attempting to write a complete franchise contract dealing with everything is naïve. Remember the contracting paradox discussed Part 1. This does, however, not mean those authoring franchise contracts should resign, succumbing to their limited ability to predict and plan for the future. Rather it means today's contracting professionals need to adapt to new ways of authoring franchise contracts that are both fair and flexible.

***What Does It Mean?***

A franchise relational contract gives up the ambition of completeness and accepts that complete planning is impossible. The franchisor tries to establish a fair and flexible framework for its dealings *and* its relationship with its franchisees. The franchise relational contract operates as a *framework*, setting forth rights and obligations as the franchisor and its franchisees pursue the franchise network's defined by the vision and objectives (completed in Step 2). But on a more general level, a relational contract is designed for *flexibility*, enabling the parties to deal with change. This means creating a sound governance structure and mechanisms to help the franchisor and franchisees make *fair*



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decisions during the entire term of the contract when business happens and there is a need to make changes in how the parties operate.

### *How Do You Do It?*

At this stage of the process, the franchise network's vision and strategic objectives and the guiding principles have been placed and used to create the "guts" of the franchise agreement.

These two pillars serve key roles in your relational contract. Here is how they work together:

- The franchise network's vision and the objectives are set and agreed upon at the very beginning of the relationship. While they can be changed over time, they act as the beacon for the relationship on what the franchisor and franchisees want to mutually achieve out of the franchise network.
- The guiding principles should be fixed and should be strictly adhered to during the whole duration of the franchise relationship.

It is now time to put in the third pillar – which is a governance framework the parties will use for managing the franchise relationship. The governance structure is crucial to sustaining the franchise relationship, ensuring continual alignment of interests and helping the franchisor and its franchisees to remain focused on the franchise network's vision and objectives. Sound governance includes incorporating these eight mechanisms into how you will jointly manage the franchise relationship: <sup>46</sup>

1. **Create a tiered management structure.** The number of tiers can vary based on the scale and complexity of the franchise network. The most common is a three-tier structure that enables the parties to focus at the operational, management, and strategic or executive levels.
2. **Establish clear roles.** Good governance ensures the franchisor and each of its franchisees to focus on managing for today (service/product delivery), managing for tomorrow (transformation and change management), managing the economics (financial and commercial management) and managing the franchise relationship. We recommend larger contracts not only clearly spell out the roles, but also establish separate roles for areas to enable proper focus. A separate transformation role is essential for medium and large-scale franchise networks where transformation and innovation are essential.
3. **Establish peer-to-peer communication protocols.** To enable efficient and effective communication, the franchisor and its franchisees should shorten the communication lines and let the right people on each side connect and communicate directly between them.



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4. **Develop a communication cadence.** To keep momentum in the franchise relationship, the franchisor should establish, and maintain, a frequency for franchisor-franchisees meetings at operational, tactical and strategic levels.
5. **Develop a process to maintain continuity.** A relationship is created by people and if people in the governance structure change, it is critical to have processes ensuring that new individuals are educated and taken on board the relationship so it ensures continuity.
6. **Establish performance management programs.** The franchisor should establish and maintain performance management and follow-up programs which may include reports, visits, meetings, exchange of information' tools and protocols, tools to continuously follow-up its franchisees', and its own, performance, etc. (i.e., their journey toward the franchise network's vision and strategic objectives).
7. **Establish dispute prevention and resolution mechanisms and tools.** Even in a strategic partnership franchise relationship, disagreements and disputes between the franchisor and one or more of its franchisees, and between franchisees, are inevitable. Therefore, the franchisor should establish and maintain fast, efficient, credible and fair mechanisms and tools to prevent and resolve, as soon as possible, such disagreements and disputes in the interest of the franchise network. A best practice example of how this works in the franchise industry is the use of a "Wise Persons Committee" which is embedded into the governance structure as a mechanism to prevent disputes (see Appendix 3 for more detail).
8. **Establish processes for risk management and contract changes.** The franchisor should finally establish a process for reviewing whether the contract needs changes to ensure that the franchise network's vision is met and the guiding principles are followed. As part of this, the franchisor should set up a credible and fair process to continuously identify, assess and deal with upcoming risks. If a need for change arises (i.e., identification of new risk or other factors), the franchisor and its franchisees should have a simple process for formalizing such changes and make them legally binding. All changes must be aligned to the adopted guiding principles.

By incorporating the eight mechanisms above into the governance structure of their franchise network, the franchisor and its franchisees will have laid the sound governance mechanisms to improve communication and joint problem-solving.

**Action:** Establish, jointly with your existing franchisees if you have any, the best governance structure and mechanisms to enable the franchisor and its franchisees to, respecting the guiding principles, achieve the franchise network's vision and strategic objectives while also dealing with change and unforeseen events.

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### Remember - Franchise Relational Contracting is a Process

Is it necessary to use the formal process we have outlined in the steps above when architecting a franchise relational contract? Should not creating a solid franchise relationship come naturally?

Many organizations have created very successful relational contracts and did not use the process we have shared - or any formal process. Instead, they discovered the journey for themselves, often by intuitively implementing the components we suggest. While getting to a good relational contract can be done without using a formal process, we do want to emphasize that using the simple five-step process we have outlined will help you facilitate the foundation for a sound franchise relational contract.

Clearly, the process we recommend in this paper is not the only one that can be used. However, we do recommend the process in this paper for three reasons.

First, we have seen firsthand that the process outlined in this paper works. It has been used by many organizations with success.

Second, we suggest following the formal process because it helps ensure the franchisor does not start from the wrong position. For example, it is easy to start by looking at the franchisee's obligations, the franchisor's rights and the money to be paid by the franchisee to the franchisor. But, as seen in this paper, this will bring out our opportunistic nature from the start. Getting out of the gate wrong can make it hard if not impossible to build a strong foundation of trust needed if the franchisor has not intuitively followed the guiding principles we outline.

Last, following the formal process we have outlined ensures that your franchise relational contract will have the essential elements of success – i.e., the franchise network's vision, guiding principles, and governance mechanisms.

We want to emphasize that using a franchise relational contract approach from a certain perspective is an all-or-nothing choice. *You cannot, if you want to succeed, play an opportunistic and a collaborative game simultaneously.* The opportunistic player will then take advantage of the collaborative player and the relationship will fail. Therefore, you have to choose, *jointly* with your existing franchisees if you have any, which game to play and stick to that choice. With that in mind, you can then determine how formal of a process you want to use for embedding the concepts we outline into your franchise relationship.

We are often asked, “*Is it really necessary for a franchise relational contract to include all five of the relational focus areas?*” For example, should you formally document the guiding principles as we suggest, or can you rather just ‘do’ them? The answer is it depends. In some franchise networks, the culture is such that they consistently live into the guiding principles (e.g., refer to the McDonald's case study in Part 5). However, research by



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Harvard University's Oliver Hart (winner of the 2016 Nobel Prize in Economic Sciences for his work on contract theory) supports that fact that most companies have a hard time living into their intentions because they become tempted to violate these essential social norms in pursuing short term gains. Hart's work on "shading" points to the fact these intentional or often unintentional behaviors erode trust, increases transaction costs, and can even lead to potential lawsuits stemming from the perceived unfairness.<sup>47</sup> His latest work (with David Frydlinger) shows that adopting guiding principles can serve as a powerful force in preventing shading.<sup>48</sup>

For this reason, we promote the concept of creating a *formal* relational contract as a way to formally document the relational 'rules' of the relationship. Doing so creates a powerful alignment of interests which can help the parties avoid shading and improve the ability to sustain a healthy relationship over the life of the franchise and franchisee relationship. This is especially important because of the dynamic nature of business and the fact that stakeholders come and go over the course of the relationship.

We highly recommend that no matter how formal or informal, it is essential to make the guiding principles a key focal point of any relational contract. A franchise relationship where reciprocity, autonomy, honesty, loyalty, equity and integrity do not exist will never establish the level of trust and transparency needed to get out of the contracting paradox discussed in the introduction.





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**PART 5: CASE STUDY: MCDONALD'S 'SECRET SAUCE'**

*(This section of the white paper contains content from the book **Vested: How P&G, McDonald's and Microsoft are redefining winning in business relationships.**)*

McDonald's deep-seated culture for long term, win-win relationships dates to McDonald's inception when founder Ray Kroc established a precedent of trust and loyalty with its business partners.

Kroc's 'System First' philosophy is often described as a three-legged stool.

One leg is McDonald's employees, a second leg is the owner/operators that run the restaurants and the third leg is McDonald's most strategic supplier partners.

The stool is only as strong as all three legs. This means that the restaurant owner/operators, suppliers and company employees each support the weight of McDonald's equally.

Kroc believed that if the restaurant owner/operators and suppliers succeeded, success would come to him.

McDonald's, its restaurant owner/operators and their suppliers have a vested interest in helping each other succeed. For one to prosper, each must prosper.

Kroc's insistence on what University of Tennessee researchers coined a "what's in it for we" (WIIFWe) mindset has created the world's most powerful franchise network. WIIFWe thinking is ingrained in the DNA of McDonald's, its suppliers and its restaurant owner/operators. Kroc's system has stood the test of time because leaders within the system have continued to honor a 'System First' approach where solutions always include the question: 'What's best for the System?'

As a salesman calling on other restaurant chains, Kroc had seen many cases where companies forced their franchised restaurants to buy goods from the company. The book, "Behind the Golden Arches" relates the widespread practice: "Tastee Freez sold freezers to its licensees. Dairy Queen took 45 cents out of every \$1.40 gallon of mix. Chicken Delight required its franchisees to purchase its chicken cookers. General Equipment provided shake machines, broilers and most other equipment to its Burger Chef franchisees."<sup>49</sup> Having captive licensees as guaranteed buyers, franchisors needed to do little else than sit back and collect money.

He was also disgusted with the franchising systems in the United States as they were known for taking advantage of owner/operators and accepting kickbacks from suppliers.

Kroc despised the short term thinking that virtually all of his competitors used.





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He envisioned a better way, one where his company - McDonald's - would ally with its restaurant owner/operators and with its suppliers that operated with long term thinking based on trust and transparency.

Kroc surrounded McDonald's with suppliers who were entrepreneurs and were not hesitant to try new things and invest in the McDonald's System. He also formed partnerships with restaurant owner/operators and suppliers so solid - so dependable, that they became known as the 'System'. The System promise? When McDonald's succeeds, they will succeed. In the System, everyone succeeds.

The System is not based on transactional contracts, but on the relational principle of creating long term wealth and competitive advantage for all three legs of the stool. This is accomplished through mitigating costs, preventing safety issues, and producing quality and innovative products that delight customers in a uniquely McDonald's way. The result is increased customer value, better brand health, and stronger business performance.

For Kroc, success was determined over the long-term. Kroc's ultimate desired outcome was profitable, individual stores serving consistent, quality products.

This meant all three 'legs of the stool', restaurant owner/operators, suppliers and McDonald's employees, must have "What's best for the System?" as the primary consideration.

Partnership and commitment to mutual goals are more important than written agreements and short-term financial considerations.

While Kroc set the tone over 50 years ago and although he has now passed on, his legacy remains. To this day, 'System First' has become shorthand for the long-term win-win behavior demonstrated by all three legs of the stool. The 'System First' philosophy is institutionalized within McDonald's, standing the test of time as new leaders, new suppliers and new restaurant owner/operators enter the System.

When you look at McDonald's success over the years, the results are impressive.

Yet, when Ray Kroc set out to create the System based on a win-win business relationship, many thought he was crazy. In his book, "Behind the Golden Arches", he wrote: "The basis for our entire business is that we are ethical, truthful, and dependable. It takes time to build a reputation. We are business people with a solid, permanent, constructive ethical program that will be in style... years from now even more than it is today."

Almost seventy years later, that remains the case.

Such a long-term success can never be based on transactional contracts.



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It can only be founded on a set of clear and agreed-upon guiding principles, vision, objectives and rules, and on a governance structure and mechanisms (including peer-to-peer relationship for each level of governance from operational to executive, peer-to-peer alignment, personal accountability, problem-solving at the lowest level possible, regular meetings, awards, social events, presentations, visits, 360-degree feedback in both formal and informal settings, ad hoc gatherings, regular business reviews, dashboards, councils, committees, etc.) that ensure continuous strategic partners' relationships and the investments (including investments in innovations) by each of McDonald's, its restaurant owner/operators and their suppliers in the continuous improvement of the System with the mindset of first expanding the pie before sharing it.

The objective is to establish an open culture that openly discusses and debates important issues and, ultimately, decides based on the 'System First' thinking aimed at how to best achieve the strategic plan. This sometimes means that an individual stakeholder does not 'win'.

In that way, McDonald's, its suppliers and its owner/operators create value rather than simply exchanging value, as in a conventional transaction-based relationship.



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### CONCLUSION AND CALL TO ACTION

Think of this analogy. Newtonian physics - largely discovered and developed by Sir Isaac Newton and many of his 17th-century contemporaries, was the mainstay of classical mechanics through much of the 20<sup>th</sup> century. When Albert Einstein came along with his theory of relativity, Newtonian physics was not abandoned but incorporated into a broader system of thinking. The same intellectual action is needed in contracting. The relational contract will not replace the transactional contract. Rather, it is necessary to incorporate transactional and relational contracts into a more comprehensive system.

In this paper, we have set out with a goal to become the go-to practitioner's guide to help individuals and organizations better understand franchise relational contracting. The bottom line is that franchise relational contracting is about enabling franchise networks to adapt to and to support the new rules of business in the new economy. It is time to put past dogmas, policies and contract templates aside and embrace contracting in the new economy.

Here are three things you can do today in your journey toward franchise relational contracting:

1. Investigate whether you suffer from problems in your franchise transactional contracts and analyze whether the problems can be understood as a result of the weaknesses we have discussed in this paper. Would a relational contract help?
2. Involve the right stakeholders. Upper management should learn of the potential advantages and economic upside associated with making the shift to relational contracting. Make them your allies and sponsors.
3. Be very forgiving and patient with naysayers and skeptics. Franchise relational contracting will most probably meet some initial resistance, regardless of the undeniable evidence of its advantages in many situations. We are all humans and rarely like change. Hesitation should not be confused with bad intentions. Instead, try education as your change agent. ***Remember, this paper is available as a free, open source document and we encourage you to share it with your colleagues, franchisors, franchisees, legal departments, legal counsels, franchise consultants and other business partners and advisors.***

If you are hesitant and still want to try, start by simply laying the foundation with Step 1 and see what happens. Start the journey from left to right on the continuum in Exhibit 1 (Part 1). It should then be clear to you this will not mean you are creating a franchise relational contract - that will only happen when you make the guiding principles the true north of the relationship. But you will then maybe have started a relationship journey that hopefully will lead you to adopt the franchise relational contracting approach in full with your franchisees.

Good luck with your franchise relational contracting!

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## APPENDIX 1

### Example Franchise Contract Language for Including the Guiding Principles

The Guiding Principles below set the tone for a collaborative franchise relationship that replaces a traditional competitive franchise relationship characterized by conflicting, negative or non-productive social norms, often leading to deterioration in trust between the franchisor and its franchisees and the creation of a dysfunctional working relationship.

#### 1. Guiding Principles

Franchisor and franchisee commit to adhere to the Guiding Principles during the establishment of their franchise relationship and to maintain that commitment throughout all the duration of their franchise relationship. This commitment is intended to assist the parties to establish a positive environment designed to purposefully build trust in the franchise relationship.

##### 1.1. Reciprocity

We will strive to make fair and balanced exchanges beneficial to the franchise network. We will place no expectation upon any other member of the franchise network we ourselves are not willing to return in kind. We recognize that reciprocity lies at the heart of the franchise network's ability to reach its goals and will ensure that short term and long-term requests benefit the franchise network as a whole.

##### 1.2. Autonomy

Neither of the franchisor or the franchisee will seek to use its power against the best interests of the franchise network or those of the relationship. We recognize that working together and being free from undue coercion ensures our ability to reach the franchise network goals and those of its members.

##### 1.3. Honesty

We will have accurate and genuine conversations at all levels within the franchise network. We will speak the truth about facts and about our intention, not withholding information being relevant for the success of the franchise network. We will also separate the facts from people's observations, perceptions, and experiences, and we will speak to our own perception. We will then look for the greater good that can come from accepting all points of view for seeking greater value for the franchise network.

##### 1.4. Loyalty

We will champion and protect the value of the franchise network and of its other members to the same extent we value our own individual interests. Our strategic partnership creates more value for all members of the franchise network than acting separately. We will therefore be loyal to the other members of the franchise network.

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### 1.5. Equity

We acknowledge that some situations will require an unequal distribution of risk, costs or investment. In those situations, we will strive to ensure that any allocation of risk, costs or investment is made in the franchise network's interests and that each member's interests have been duly considered.

### 1.6. Integrity

We will avoid opportunistic behavior and continually strive to make decisions consistent with the Guiding Principles in the best interests of the franchise network as a whole. To achieve results, we will align our actions with our words. We will do what we say.

### 1.7. Transparency

We will transparently and reciprocally share correct information in the interest of the success of the franchise network as a whole. We will strive to transparently make as much information available as soon as possible to allow the other members of the franchise network to make good decisions in the interest of the franchise network, for themselves and for the relationship.

### 1.8. Franchise network superior interest

We will make decisions and act firstly in the best interest of the franchise network in priority to our own individual interests.



## APPENDIX 2

### EXAMPLE CONTRACT INTERPRETATION CLAUSE

#### Applicable Law and Interpretation of the Agreement

1.1 The Agreement shall be governed by the laws of \_\_\_\_\_

1.2 The Parties acknowledge that the dynamic and complex nature of their relationship will likely mean the Agreement will have ambiguities and potential omissions not explicitly set out in the Agreement. The Parties commit to using their best efforts to collaboratively resolve any misalignment or disputes which may arise in their pursuit toward the Shared Vision and Desired Outcomes using the Guiding Principles as the basis for decision making and actions.

1.3 If:

- a) the Agreement does not clearly specify a Party's right or obligation in a particular matter,
- b) there are difficulties in construing the Agreement
- c) there is a conflict between the terms and conditions within or between different documents of the Agreement,
- d) there is a conflict between one or more of the Guiding Principles and explicit rights or obligations otherwise stated in the Agreement,

the Agreement is to be interpreted as set out in this clause.

#### 2. Interpretation Guidelines

2.1 Interpretation process between the Parties

Any disagreement about interpreting the Agreement shall be handled in the governance framework appearing in Schedule [●].

2.2 Permitted interpretation data

For interpretation of the Agreement, only the Agreement, and no other written or verbal commitments or promises that have preceded the Agreement, may be used.

2.3 Principles for interpretation

Interpretation of the Agreement shall be done by applying the Guiding Principles so the interpretation that best achieves the Shared Vision and the Desired Outcomes shall prevail. The following sets out how this general rule of interpretation shall be applied in three scenarios.



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- a) Should an interpretation of the Agreement based on the Shared Vision and the Desired Outcomes conflict with one or more of the Guiding Principles, then the interpretation that best creates conditions to achieve the Shared Vision and the Desired Outcomes without conflicting with the Guiding Principles shall prevail. The ends do not justify the means.
- b) Should a conflict occur between the Guiding Principles, the Parties should use the principle of Integrity for the basis of decision or actions enabling the most consistent interpretation.
- c) Should there be a conflict between the Guiding Principles and explicit rights or obligations otherwise stated in the Agreement, the explicit rights and obligations shall prevail. If, however, the conflict is material, those rights and obligations shall be aligned to the Guiding Principles.



### APPENDIX 3

## EXAMPLE OF WISE PERSONS' COMMITTEE IN A FRANCHISE NETWORK

A Wise Persons' Committee is a permanent (rather than *ad hoc*) committee whose members are individuals who:

- Have high credibility within the franchise network (that's why they are called "Wise Persons")
- Are very familiar with the franchise network and can thus recognize where its best interests lie
- Are not then actively involved in the network
- Have no personal interest in the decisions and actions of the franchisor or franchisees or in the substance or outcomes of their recommendations, except for the sole objective of seeing the network succeed while continuing to adhere to its mission and values and to its Guiding Principles

Most often, the members of a Wise Persons' Committee are former franchisees who have achieved success, former franchisor's executives who have gained considerable credibility both among franchisees and with the franchisor, and/or experienced individuals who are, or have been, close to the franchise network. The members of the Wise Persons' Committee are appointed by a joint decision of the franchisor and its franchisees. Franchisees must acknowledge that the individuals appointed to the committee are not dependent on the franchisor and have nothing to gain by favoring the franchisor or any other member of the network. A credible and active Wise Persons' Committee represents the collective consciousness of the franchise network, buttressing its mission and values and its common interests. This is therefore a mechanism that, when properly organized, will afford very useful opportunities, in particular for ironing out problems, differences and disagreements within the network.

The primary role of a Wise Persons' Committee is to provide, within a short time frame, the opinion of individuals recognized as "wise" and "neutral" to all members of the franchise network (franchisor's executives, franchisees, immediate partners, etc.), on any decision or action (whether by one or more franchisees or by the franchisor) that:

- Creates a problem
- Seems to violate the "relational contract" between the franchisor and its franchisees or the mission and values of the franchise network
- Does not seem primarily in the interests of the franchise network as a whole



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In some cases, the franchisor or one or more franchisees can also submit to the Wise Persons' Committee disagreements that arise within the franchise network that the parties cannot resolve themselves. In those cases, the Wise Persons' Committee makes recommendations on potential avenues to find a resolution in the best interests of the network.

The outcome of the deliberations of a Wise Persons' Committee is recommendations rather than decisions. However, because those recommendations are ordinarily communicated to all the franchisees and to the franchisor, they carry definite weight within the network.

If the committee members also have influence over the parties to a dispute (from their expertise and/or reputation within the network), they can also, upon request, act as conciliators to facilitate a fair, and mutually acceptable, settlement.

Even when no specific situation is put to the Wise Persons' Committee, it meets regularly to keep up to date on developments within the franchise network and on the opportunities, issues, and challenges that arise along its way. The committee will thus be prepared to act quickly when necessary, and its recommendations will be correspondingly better and more relevant.

The experience of the committee members and the fact that they have no stake in the outcome mean they bring a different perspective and can often see the forest rather than just the trees. They are often in a better position to see the longer-term consequences of a dispute for the network and to recommend fresh options for resolving it.

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**Kate Vitasek** is an international authority for her award-winning research and Vested® business model for highly collaborative relationships. Vitasek, a Faculty member at the University of Tennessee, has been lauded by *World Trade Magazine* as one of the "Fabulous 50+1" most influential people affecting global commerce. Her work has led to seven books, including *Vested Outsourcing: Five Rules That Will Transform Outsourcing*, *Vested: How P&G, McDonald's and Microsoft Are Redefining Winning in Business Relationships* and *Getting to We: Negotiating Agreements for Highly Collaborative Relationships*. Vitasek has also been featured on CNN International, Bloomberg, NPR, and on Fox Business News.



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**ENDNOTES**

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