THE UNIVERSITY OF TENNESSEE, KNOXVILLE
HASLAM COLLEGE OF BUSINESS

Unpacking the Academics of Sourcing

Unpacking the Academics of Sourcing

Lessons Learned from Great Academics

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If I have seen a little further, it is by standing on the shoulders of giants.

Isaac Newton

INTRODUCTION

Over the past 20 years, we have been privileged to research strategic business relationships with one focus: to find a better way for organizations to create – *and sustain!* – their most important business relationships.

Along the way, we have had the opportunity to work with organizations that are developing partnerships that are driving innovation, delivering amazing performance results and cost reduction initiatives – and even winning awards. Our research has led to seven books (soon to be eight), including *Vested: How P&G, McDonald's and Microsoft are Redefining Winning in Business Relationships*, *Strategic Sourcing in the New Economy*, and *Vested Outsourcing: Five Rules that Transform Outsourcing*.

At the same time, we have spent literally hundreds of hours studying academic research spanning the fields of business, economics, law, psychology, and sociology. These fields have all had significant research and insightful learnings that businesses should pay attention to. We have literally read through thousands of pages of research covering topics such as the nature of the firm, game theory, relational contracting, market forces, game theory, free markets, contract theory, transaction costs economics, incomplete contracts, and preventive law practices.

Along the way, we have been exposed to a couple of hundred academics who have spent hundreds of hours—if not years—on their research, theories, and concepts. Often, the lessons learned from the research are pioneering—even game-changing. We have come to term many academics as "big thinkers" because several have won Nobel Prizes and racked up numerous accolades in the academic community.

Big Thinking With Too Little Traction

While a few of these big thinkers have gotten significant traction with their work, far too many of their ideas have failed to get traction. What has struck us over the years was just how prescient these big thinkers were, but how slow or hesitant businesses have been in understanding and applying their concepts and principles. Why have so few business people ever heard of Oliver Williamson (he won a Nobel Prize in Economics in 2009) and how come they have no clue what Transaction Cost Economics is and why they should care? Or what about Oliver Hart's Nobel Prize-winning research on contract theory and later his fascinating work on contracts as reference points and contractual shading?

We believe the slow uptick of such sage advice is because many of these academic's work is the victim of the three rules of real estate: location, location, location. The bulk of their ideas are published in academic journals and books written for and read by fellow academics. There, the advancement of ideas and theory far outweighs the actual implementation of the concepts.

Unpacking The Practicalities

Our goal for this paper is to help close the gap between and theory and practice. In essence, we are setting out to "unpack" the ideas of 78 of our favorite academics and show how their ideas are not only relevant – but can help improve how businesses operate. In writing this paper we have tried to translate each of these academics' ideas into a more palatable and direct form and show how it relates to what modern business practitioners and busy business executive are doing in the real world.

Structure of This Paper

This white paper unpacks the learnings from some of the world's biggest thinkers into an easy-to-digest paper. For each big thinker, we distill the learning into a one-page overview with the following format:

- Provide a brief background about who each person is
- Try our best to summarize the significance of their work succinctly in a few paragraphs
- Conclude with advice to practitioners
- Include a link to their most significant work where you can learn more.

Think of it as the ultimate cheat sheet for business professionals!

We profile 78 academics of sourcing that fall into four categories.

Big Thinkers in Business

We start by featuring 19 fellow business school colleagues with unique angles to share. These individuals, such as Michael Porter, Clayton Christensen, and Kathleen Eisenhardt, are likely to be the ones you may have heard of because their work is often featured in trade press, Harvard Business Review articles, or even best-selling business books. If you are familiar with their work feel free to pass

The Economics of Commerce

Our next focus is on 23 big-thinking economists – the real unsung heroes behind how to get the fundamentals of the business right. Here we feature Nobel Prize winning economists such as Ronald Coase, Robert Solow and John Nash. We unpack the Olivers - Oliver Williamson and Oliver Hart – whose work has personally inspired our research on relational contracting and sourcing business models. We always attempt to unpack their pioneering thinking and create a bridge from their academic brilliance to how it their idea apply to modern sourcing.

Learning From Lawyers and Legal Scholars

You might be saying No! Not the lawyers! But don't fear. Here we feature legal scholars such as Stuart Macaulay and Ian Macneil who advocate for a common-sense approach when it comes to contracting. In total we highlight the work of 15 legal scholars who all have both significant and interesting research that can help businesses rethink their approach to contracting.

The Social Science and Psychology of Sourcing

Lastly, we share insights from 21 social and political scientists as well as psychologists. What? you might ask? How does social science and psychology play into the world of sourcing and contracts? Here we share insights that will undoubtedly help organizations create more fair and balanced trading partner relationship and will help you be much more rationale in how you approach sourcing – especially strategic sourcing. For example, we profile Daniel Kahneman and Amos Tversky to help show the impact of biases that can lead to suboptimal sourcing. We highlight the works of Douglas North, Ernst Ferh and Simon Cachter who delve into concepts such as the impact of social norms on creating a high-performing culture of success. We also profile the work on Amy Edmonson and Paul Zak who provide insights into building more trusting relationships.

The Bottom Line

The bottom line? We hope the insights from the ideas shared in this paper will help you improve your bottom line with better sourcing practices. These big thinkers' theories and concepts are seminal in laying the foundation for the development and success of strategic sourcing and modern outsourcing agreements if you choose to heed their wisdom.

PART ONE:

The Big Thinkers of Business

In this first section, we included a number of academics and thought leaders who specifically researched and wrote for a business audience. Sometimes they wrote to communicate what they felt was 'best practice'. Other times, they wrote to challenge business professionals to think differently.

Some of these academics lit the world on fire with their ideas. For example, in the early 1990s, business gurus such as Peter Drucker's challenge to organizations to "do what you do best and outsource the rest" started a trend in the late 1990s for what is today modern outsourcing.

As you read about the Big Thinkers of Business, you will likely see many familiar names (unlike in other sections of this paper where it is often unusual if a typical businessperson has heard of many of the academics we profile). If you have read their works – or better yet applied their ideas – feel free to skip past the page where we profile them. Or – take two minutes and refresh your thinking on why these individuals are truly pioneers in the business world.

Clay Christensen: Disruptive Innovation in Outsourcing

Clayton Christensen (1952 – 2020) was the Kim B. Clark Professor of Business Administration at Harvard Business School put his name on the map with his seminal work ***The Innovator's Dilemma****, which introduced the term "disruptive innovation." The subtitle of the book is revealing: When New Technologies Cause Great Firms to Fail. His book was a bestseller in 1997 and received the Global Business Book Award for the best business book of the year.*

It is important for companies to realize that it's only a matter of time for disruptive innovation to take hold – not just in technology, but in the ways organizations undertake processes including sourcing and contracting.

The Innovator's Dilemma[1] points out a fatal flaw in business logic. Companies focus on things that have made them successful because that is where the money is. They are often blind or resistant to new ideas and innovations because it disrupts the status quo. In his summary, Christensen says, "Companies must not throw out the capabilities, organization structures, and decision-making processes that have made them successful in their mainstream markets just because they don't work in the face of disruptive technological change."

Why is this? Christensen says it is because disruptive technologies "rarely make sense during the years when investing in them is most important, conventional managerial wisdom at established firms constitutes an entry and mobility barrier that entrepreneurs and investors can bank on."

We can learn some powerful lessons from Christensen's big thinking as it applies to how organizations approach sourcing – especially with how they outsource non-core services. Why? Outsourcing, by its very nature, is disruptive; this is especially true the first time a company does it. But today, most companies have outsourced multiple parts of their business. It's no longer new. The status quo of how we outsource has hit a plateau, and we need something new—a big dose of disruptive thinking.

Christensen offers advice for overcoming the innovator's dilemma. First, managers must understand "intrinsic" conflicts. Intrinsic conflicts in how organizations outsource are not only prevalent but also preventing the industry from moving forward. Second, managers need to be willing to disrupt their own businesses before others do it for them. By recognizing and embracing disruptive technologies and business models, managers can position their organizations to thrive in the face of rapid change and innovation.

Finally, Christensen suggests that managers need to "create a context in which each organization's market position, economic structure, developmental capabilities, and values are sufficiently aligned with the power of their customers that they assist, rather than impede, the very different work of sustaining and disruptive innovators."

Advice to Practitioners: Organizations need to consider ways to disruptively innovate in how they are approaching sourcing. One way to do this is to consider alternative sourcing business models such as more modern and less used Performance-Based agreements and a highly collaborative win-win Vested business model. Procurement professionals might start by thinking about what passed-down knowledge they need to 'unlearn' before they can make a move to implementing their own disruptive innovations in sourcing and contracting. Practitioners can also ensure that they are employing the most appropriate sourcing business model by using the Sourcing Business Model toolkit available at www.vestedway.com/

[1] https://www.amazon.com/s?k=the+innovators+dilemma&i=digital-text&crid=1D8Q1TUGC6FRV&sprefix=the+innovators+%2Cdigital-text%2C147&ref=nb_sb_ss_ts-doa-p_1_15

Prahalad and Hamel: Corporations and Core Competence

In 1990, C.K. Prahalad and Gary Hamel, teamed to write one of the Harvard Business Review's most influential articles on the nature of the modern firm – "The Core Competence of the Corporation."[2] *They introduced the concept of core competence—which they called the "most powerful way to prevail" in global commerce. Prahalad, who died in 2010, was the Paul and Ruth McCracken Distinguished University Professor of Corporate Strategy at University of Michigan Stephen M. Ross School of Business. Dr. Gary P. Hamel is an American management expert, and a founder of Strategos, an international management consulting firm based in Chicago.*

Prahalad and Hamel defined core competencies as the "collective learning in the organization, especially how to coordinate diverse production skills and integrate multiple streams of technologies." Simply put, a core competency is the combination of resources and skills that distinguish a firm in the marketplace.

They noted that core competence encompasses communication, involvement, and a "deep commitment to working across organization boundaries." Prahalad and Hamel contended that by maintaining "world manufacturing dominance in core products," a company would "reserve the power to shape the evolution of end products." The core competence concept helped focus managers on business and market essentials and also identified the areas that were non-core. Thus, the identification of core competencies moved in line with the growth of outsourcing. It can be argued that Prahalad and Hamel's core competency idea boosted both insourcing by identifying critical internal functions and outsourcing, by identifying functions suitable for outsourcing.

As part of their work, Prahalad and Hamel developed a Core Competence Model. The model focuses on a combination of specific, collaborative, integrated and applied knowledge, skills and attitudes. The model "should not focus on fighting off the competition, but on creating a new competitive space." The model comprises four core competencies:

1. Resources: the sources for the development and acquisition of skills and technologies
2. Capabilities: The possibilities to build core competencies
3. Competitive advantage: the challenge to acquire and develop the largest possible market share of core products
4. Strategy: the strategy to develop the largest possible market share of finished products

Identifying the core competency permits an organization to safely and wisely outsource non-core activities. It also creates conditions for collaboration both within the organization and outside of it. In other words, "Do what you do best, and outsource the rest!"

But what happens if you have heeded Prahalad and Hamel's advice and outsourced, but outsourcing is not living up to the promise? If you outsourced because it was not a core competency, don't think about bringing the work back in-house. Instead, look in the mirror and understand how you outsourced. Perhaps you are using the wrong sourcing business model for your outsourcing deal or have created a dysfunctional contract laden with perverse incentives.

Prahalad and Hamel were prescient and visionary back in 1990. "Core competencies are the wellspring of new business development. They should constitute the focus for strategy at the corporate level," they concluded.

Advice to Practitioners: The importance of the core competency concept developed by Prahalad and Hamel is seminal because it laid the groundwork for how the modern company should operate and how it should outsource. Remember, if you have outsourced an activity because it is 'non-core', then recognize this in the outsourcing approach, that is leave room for the supplier or service provider to use their expertise (because it is a core process for them).

[2] https://hbr.org/1990/05/the-core-competence-of-the-corporation

Quinn and Hilmer: The Approach to Strategic Outsourcing

Professors James Brian Quinn and Frederick G. Hilmer did groundbreaking work that identified and evaluated the core competencies that go into strategic outsourcing decisions—in the early 1990s. Quinn, who passed in 2013, was professor of Business Administration in The Amos Tuck School of Business Administration at Dartmouth College; Hilmer was the President and eighth Vice-Chancellor of the University of New South Wales.

Quinn and Hilmer collaborated on an article published by MIT Sloan Management Review, "Strategic Outsourcing.[3]," which outlined two strategic approaches that "when properly combined, allow managers to leverage their companies' skills and resources well beyond levels available with other strategies."

- "Concentrate the firm's own resources on a set of 'core competencies' where it can achieve definable preeminence and provide unique value for customers.
- "Strategically outsource other activities — including many traditionally considered integral to any company — for which the firm has neither a critical strategic need nor special capabilities."

These ideas that were considered "new" at the time – but actually had been examined in academic research for many years—have become part of the modern outsourcing playbook, leading to the concepts of collaborative sourcing and relational contracting based on organizations' most strategic relationships.

They noted that when thinking about what "core" means, "the concept requires that managers think much more carefully about which of the firm's activities really do — or could —create unique value and which activities managers could more effectively buy externally."

Their study of successful (and unsuccessful) corporate examples showed that effective outsourcing applied the following concepts.

- Skill or knowledge sets, not products or functions. "Executives need to look beyond the company's products to the skills or systems that actually create a maintainable competitive edge."
- Flexible, long-term platforms — capable of adaptation or evolution. "Too many companies try to focus on the narrow areas where they currently excel, usually on some product-oriented skills."
- Unique sources of leverage in the value chain. "Effective strategies seek out places where there are market imperfections or knowledge gaps that the company is uniquely qualified to fill.
- Areas where the company can dominate. "Companies consistently make more money than their competitors only if they can perform some activities — which are important to customers — more effectively than anyone else."
- Elements important to customers in the long run. "At least one of the firm's core competencies should normally relate directly to understanding and serving its customers."
- Embedded in the organization's systems. "Maintainable competencies cannot depend on one or two talented stars…whose departure could destroy a company's success. Instead, the firm must convert these into a corporate reputation or culture that outlives the stars."

They concluded that companies could substantially leverage their resources through strategic outsourcing by: "(1) developing a few well-selected core competencies of significance to customers and in which the company can be best-in-world; (2) focusing investment and management attention on them, and (3) strategically outsourcing many other activities where it cannot be or need not be best."

Advice to Practitioners: Quinn's and Hilmer's insights into strategic outsourcing resonate strongly today, making the value of outsourcing clear, if it is done the right way through collaboration, trust and shared values. It is also important to build awareness throughout the organization on the foundations and benefits of the new sourcing and contracting approach. It is also important to place those outsourcing agreements that are critical to the organization under the right level of governance and strategic focus.

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[3] https://sloanreview.mit.edu/article/strategic-outsourcing

Michael Porter: The Shared Value Path

Michael Porter is the Bishop William Lawrence University Professor at Harvard Business School. He, along with Mark R. Kramer, wrote about the "big idea" of "Creating Shared Value."[4] In 2011, in a long and highly influential Harvard Business Review article. Porter's shared value premise is a natural progression of his career work on company strategy and the competitiveness of nations and regions.

The HBR article begins by acknowledging that capitalism is "under siege" because business is increasingly "viewed as a major cause of social, environmental, and economic problems. Companies are widely perceived to be prospering at the expense of the broader community."

And even embracing corporate social responsibility—a widespread trend these days— is not enough because "the more business has begun to embrace corporate responsibility, the more it has been blamed for society's failures." A major part of this problem lies with companies themselves: they are stuck "in an outdated approach to value creation that has emerged over the past few decades. They continue to view value creation narrowly, optimizing short-term financial performance in a bubble while missing the most important customer needs and ignoring the broader influences that determine their longer-term success."

In a short video for the Huffington Post World Economic Forum, Porter summarized his ideas on shared value. He says that the basic idea of creating shared value "is about actually applying the capitalist model to addressing issues in society," such as hunger, the environment, water and health.

It goes beyond the CSR approach that's based basically on charity and fair trade, which Porter asserts is not a sustainable solution – "it's just redistribution." Shared value is a logical progression from CSR, he says, because incomes are raised for everyone, not through charity and by being a "good corporate citizen," but by "being a better capitalist – it's a win-win."

CSR was an effort to be responsible by contributing to the community, he continues. The idea of shared value is a much "bigger opportunity, it's rethinking how we practice capitalism". In that regard, Porter talks about the three opportunity "buckets" that benefit all: the product opportunity, which addresses the many social dimensions embodied in a product, often in relation to customers whose needs have not been served.

The second bucket is to look at the value chain and open up new opportunities to save on energy, save on packaging, and actions that companies can employ to provide more beneficial impacts on suppliers that benefit them and their employees. The third opportunity is a "cluster," or the businesses and institutions around the company – "the better that ecosystem, the better and more effective and competitive the company can be."

The idea here, Porter continues, is to "get capitalism working not against the interests of society and the community, but actually integral to addressing the interests of society and the community."

This is where the Vested business model that provides a pathway to implement a trusting, collaborative relationship that creates and shares value for all parties in a business or outsourcing relationship makes those lofty goals entirely possible.

As Porter says, "Changing the public's attitude to business will be based on what we in business do, what we achieve, what we accomplish. Shared value is a way to get businesses thinking about that question. "

Advice to Practitioners: In a global economy where capitalism is seen as the scapegoat for the economic and financial ills that we face, Porter's ideas present a way for capitalism to be the solution, not the problem. To do that, "companies must take the lead in bringing business and society back together," Porter says. As we teach in Vested, the opportunity to create more shared value comes from collaborating with suppliers so that customers can leverage the expertise of both parties. By collaborating with suppliers, companies can create a more sustainable and socially responsible supply chain, which in turn can generate economic benefits for both the companies and society, thus overcoming the criticism that society has.

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[4] https://hbr.org/2011/01/the-big-idea-creating-shared-value

Jeffery Dyer: Relational Rents

Jeff Dyer (Ph.D. UCLA), is the Horace Beesley Professor of Strategy at the BYU Marriott School of Business. He was recently ranked #1 on a list of most impactful management scholars in the world (based upon citations and Google searches) among those who received their Ph.D.'s after 1991. He was also ranked as the 4th most cited management scholar from 1996-2006, and his "Relational View" article in Academy of Management Review was the 2nd most cited article in business from 1998-2008.

Jeffrey Dyer's research on relational rents has provided valuable insights into how companies can generate additional profits through inter-firm relationships. Relational rents refer to the extra profits that arise from collaboration between firms that go beyond what would be possible through standard market transactions. His work has shown that relational rents can be a significant source of competitive advantage, but they can be realized only through effective governance processes and a long-term commitment to collaboration with the selected partner.

Dyer's research was built around strategic alliances, which are partnerships between firms that involve a higher level of collaboration and coordination than standard buyer-seller relationships. The research carried out by Dyer showed that strategic alliances could generate significant relational rents for the partners involved. For example, by sharing knowledge and expertise, firms can develop new products and technologies that they would not have been able to develop alone. By pooling resources, firms can achieve economies of scale and reduce costs. By sharing risks, firms can spread the cost of investment and reduce their exposure to market fluctuations.

However, Dyer has emphasized that the potential for relational rents can be realized only through effective governance processes. This means that the partners must have a shared understanding of the goals and objectives of the alliance, and they must have mechanisms in place to manage conflicts and resolve disputes. Governance processes can include formal contracts, joint decision-making processes, and monitoring and evaluation mechanisms. We would add to Dyer's recommendations considering the use of independent third parties who can ensure that the parties keep on track and realize the relational rents.

Dyer's research has also shown that there are risks associated with strategic alliances. For example, there is a risk that the partners may not share the same goals or have conflicting interests. There is also a risk that the partners may not be able to effectively manage the collaboration, leading to delays, cost overruns, and other problems. To mitigate these risks, Dyer has emphasized the importance of selecting the right partners, building trust, and developing effective governance processes.

Finally, Dyer's research on relational rents has provided valuable insights into how firms can create competitive advantage through inter-firm relationships. By collaborating with other firms through strategic alliances, firms can generate significant benefits that go beyond what would be possible through standard market transactions. However, achieving these benefits requires careful attention to governance processes and a long-term commitment to collaboration. Dyer's work has important implications for firms seeking to create sustainable competitive advantage in today's complex and dynamic business environment.

Advice to Practitioners: Effective governance processes are, according to Dyer, processes that rely on trust and collaboration as compared to power-based processes relying on third-party enforcement of a contract. They also establish knowledge-sharing routines with their suppliers based on transparency and reciprocity. In creating a Vested agreement, the parties address a number of the points highlighted by Dyer's research. First, the process starts with the relationship ensuring Trust and Compatibility are well-founded. This is followed by identifying and providing clear measurements of the desired outcomes for both parties. Last, the process puts a lot of effort into creating a robust and effective governance process that seeks to maintain ongoing alignment between the parties.

David Faulkner: The Value of a Cooperative Strategy

David Faulkner is Emeritus Professor of Strategy at Royal Holloway, University of London, and formerly Visiting Research Professor, The Open University. He has written extensively about the need for cooperative, rather than purely competitive, strategic business relationships and alliances. Since the early 1990s Faulkner has studied the "essence" of competitive strategy, and the challenges involved in integrating cooperation as part of the competitive mindset. One of his books is ***International Strategic Alliances: Cooperating to Compete***[5] *(1995). The strategies of cooperation have been his most common theme.*

In one of his papers on strategic alliances and the factors that influence success and failure, Faulkner notes that the advent of globalization and the integration of markets has meant that organizations - "for survival" – enter into strategic alliances. He concludes that successful alliance relationships are "characterized by higher levels of commitment, collaboration, communication, and trust than are less successful alliances." Further, success is enhanced by ensuring that the "alliance partners have a fit with respect to alliance objectives, its mechanics of operation and the performance evaluation criteria."

So simply put, increasing globalization and competition has meant that companies can't really go it alone very effectively in the marketplace anymore. Which brings us to Faulkner's idea of "cooperative strategy." Cooperative strategy, he writes, is the attempt by organizations "to realize their objectives through cooperation with other organizations rather than in competition with them."

The focus turns to the benefits gained through cooperation, and "how to manage the cooperation" in order to make the benefits real. Faulkner says a cooperative strategy "can offer significant advantages for companies that are lacking in particular competencies or resources to secure these through links with others possessing complementary skills or assets." In addition, a cooperative strategy can provide "easier access" to new markets, and "opportunities for mutual synergy and learning."

And Faulkner continues even further into Vested thinking by placing special emphasis on trust, because it reduces the perception of risk, and collaboration as the "key dimension" of a strategic alliance relationship. "Partners that trust each other generate greater profits, serve customers better, and are more adaptable," Faulkner says. When exchanges are governed by trust, he continues, transaction costs, such as bargaining and monitoring costs, can be reduced. "Studies suggest that one critical factor determining alliance performance is the degree of trust between alliance partners. Indeed, it has been argued that trust is so important to alliances that it is considered the cornerstone of the strategic partnership success."

Faulkner is direct about the value of collaboration: "Alliance partners must collaborate to achieve their strategic objectives." And this is equally true for outsourcing relationships or joint ventures. Collaborative associations are interactive and adaptive in nature, he continues, and understanding the nature and scope of collaboration is "essential in analyzing the operation and success of an alliance. A highly collaborative relationship provides the flexibility and adaptability necessary to overcome uncertainties, resolve conflicts and achieve mutually beneficial outcomes."

Advice to Practitioners: Cooperation should be high on the agenda of an organization's corporate strategy because it is, as Faulkner rightly writes, an enabler of innovation and a means to share resources. While cooperative strategy is not a new idea, it is also not an alternative to either competitive or corporate strategy Faulkner and the writers of this paper are saying that cooperative strategy is ignored at a firm's peril. The Vested methodology seeks to help the parties to an outsourcing arrangement build trust and to put in place the governance processes that Faulkner recommends.

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[5] https://www.amazon.com/International-Strategic-Alliances-Co-operating-1994-11-01/dp/B01K92Y978/ref=sr_1_4?crid=18B8QZTRV5NZ5&keywords=%22International+Strategic+Alliances%22&qid=1673890683&sprefix=international+strategic+alliances+%2Caps%2C121&sr=8-4

Daniel Corsten: Managing Relationships between People, Customers and Organizations

Daniel Corsten is a Professor in the Department of Technology and Operations at IE Business School. He was Visiting Professor at INSEAD, Wharton School and London Business School. He has been a pioneer in the study of collaborative relationships dating back to being a founding academic of the Efficient Consumer Response Initiative (ECR), a major worldwide collaborative movement in the retail industry. Corsten's latest work includes his paper, "Mitigating the Deleterious Effects of Punishments in Buyer-Supplier Relationships."[6]

In this paper, Corsten says that while punishment is ubiquitous in the practice of inter-organizational relationships, a large body of research demonstrates that the use of coercive power, and more specifically punishment by one party, has "deleterious attitudinal effects on the partner." It was also found that setting targets and punishing failure led to minimalist performance; suppliers performed to a level that would just avoid punishment and no further. This level was often slightly below the target, but not by enough that it triggered punishment.

Now, that may seem simple and obvious, but why, then, is the use of market or financial power so prevalent in business relationships? Corsten researched survey data from 346 automaker suppliers to "confirm that buyer punishment of a supplier has a detrimental impact on supplier trust, conflict, and self-reports of supplier operational performance."

In other words, Corsten's research has found "only deleterious effects of punitive actions. This has led some researchers to contend that power, and particularly its negative forms such as punishment, is ineffective, and instead, relationship success is associated with the absence of exercise of coercive power."

There is another side to using coercive power that Corsten recognizes: while power and punishment can be used to exploit and dominate the other party, they can also be employed to lead, coordinate, and collaborate. Our research at the University of Tennessee parallels Corsten's findings, but through case-based research.

There are also echoes in Corsten's work, of the concept of 'Shading' which was drawn from the Nobel Prize winning research of Oliver Hart. Suppliers who are victims of power-based coercion, particularly where they feel unfairly treated, will push back against the buyer, either covertly or overtly and seek to recover their position. There is a more detailed discussion on Shading on page 36.

Corsten also found that companies naturally have instincts to use their power and that "power continues to play a central role in business practice." This is clear-headed and full of common sense. When power is abused it endangers the relationship and when used positively it builds sustainable relationships and lasting benefits. The duality Corsten addresses is unfortunate in a way, but it is also the reality of the business world we live in. How to use your power is a choice.

Advice to Practitioners: The Vested approach is a path that ends the abuse of power in business relationships (especially in those that are unequal) in favor of a new mindset—a change from self-interest and "me" tactics to credible, collaborative relationships based on cooperation and sharing value. Corsten captures the simple essence of the Vested approach: "My research shows that collaboration, trust, commitment and rewards are the magic ingredients of any successful relationship." By aligning incentives to deliver the results that both parties are looking for, the Vested model provides a more effective path to performance than can be achieved by the use of coercive power.

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[6] https://www.researchgate.net/publication/265276484_MITIGATING_THE_DELETERIOUS_EFFECTS_OF_PUNISHMENTS_IN_BUYER-SUPPLIER_RELATIONSHIPS

Susan Helper and Rebecca Henderson: The High Cost of Cost Cutting

Susan Helper, PhD, is the Frank Tracy Carlton Professor of Economics at Weatherhead School of Management, Case Western Reserve University. She served as the Chief Economist of the U.S. Department of Commerce from 2013-2015, and as Senior Economist at the White House Council of Economic Advisors in 2012-2013. Rebecca M. Henderson, FBA is an American economist, currently the John and Natty McArthur University Professor at Harvard Business School. From 1998 to 2009, Professor Henderson was the Eastman Kodak Professor of Management at the Sloan School of the Massachusetts Institute of Technology.

U.S. automobile companies have long been known for using their power. Susan Helper and Rebecca Henderson's National Bureau of Economic Research paper titled "Management Practices, Relational Contracts, and the Decline of General Motors."[7] Describes General Motors as having adversarial and arms-length supplier relationships dating back to the 1950s. In 1990, GM decided to step it up further when it promoted Dr. Ignacio Lopez to director of worldwide purchasing operations.

Lopez suddenly was in control of a $57 billion global budget. A fan of Peter Kraljic's Matrix that emphasizes using "leverage" strategies, Lopez instituted aggressive competitive bidding strategies. Lopez didn't stop with purchase requirements in the "leverage" category. He amped up the pressure on suppliers across the board, radically changing the established pricing principles. Prices would no longer be set by a supplier's production costs. Rather, GM would set the price, and suppliers' production costs had to be managed to support the price.

Writer John Eisenhammer described the new Lopez pricing protocols in a newspaper article: "Having established such a price, he [Lopez] would then take a margin for the supplier – 'since obviously, they must make a profit' – and whatever is left is production costs plus the car company's own profit. This did not imply a drop of 5 or 10 per cent, but 20 to 30 per cent or more." Lopez was known for saying, "I do not want to hear any more that prices are already down too far and you are making no profits. We have to change our attitudes. No more excuses."

No one can debate that heavy-handed cost-cutting works in the short term. GM saved a whopping $1.1 billion in 1991 and $2.4 billion in 1992 – just two short years after Lopez took the helm of GM's procurement organization. The company called the boost in profitability the Lopez effect. Little did GM C-suite executives know that the Lopez effect also caused long-term negative impacts that would last for the next two decades.

In 1993, Lopez left GM to take a position with Volkswagen. GM suppliers were glad to see the proverbial pit bull of procurement move on. While Lopez is credited with delivering a cost-reduction benefit to GM, most would argue that his muscular approach for executing his plans resulted in profound damage to GM's supply chain. Helper and Henderson's paper shows a direct connection to GM's treatment of suppliers to its demise.

Simply put, in a changing marketplace that counted on suppliers to bring new ideas and add value, GM was the suppliers' least preferred customer. Suppliers shared innovative products and technologies with every other customer before going to GM. Many argue the lack of supplier contribution contributed to GM's declining finances and ultimate bankruptcy.

Advice to Practitioners: It has been over two decades since Lopez reigned over GM's supply chain. New directors implemented policies more favorable to suppliers, but the stigma remains. The lesson is profound. Power may work for a season, but seasons always change. Businesses must recognize that supplier relationships are not a zero-sum game and that treating suppliers fairly and with respect can lead to a more sustainable and successful business in the long run, as trust and loyalty are built and maintained over time.

[7] https://www.aeaweb.org/articles?id=10.1257/jep.28.1.49

Leslie Willcocks: Trust Based Contracts

Leslie P. Willcocks is Emeritus Professor of Work, Technology and Globalization at the London School of Economics. He also served as governor of the Information Systems and Innovation Group. Professor Willcock's major research interests include service automation, robotic process automation, cognitive automation of knowledge work, artificial intelligence, digital transformation and emerging technologies.

Research in outsourcing relationships also proves there is a tremendous business value when developing highly collaborative relationships with service providers. Professor Leslie Willcocks distinguished between power-based and trust-based outsourcing contracts. In a study involving 1,200 organizations, good relationship management within trust-based arrangements made an astounding 40 percent difference in cost savings.[8]

In another study on business process outsourcing (BPO) relationships, Willcocks found that the presence of a "partnership view" explained the difference between high performing relationships and typical relationships. The partnership view was expressed in behaviors such as a willingness to collaborate, to understand each other's objectives, to resolve conflicts fairly and to renegotiate the deal if it proved to be financially unsound for one of the parties. Willcocks is also critical of outsourcing arrangements that are solely based on cost reduction, highlighting instead the benefits of strategic collaboration and innovation.

In research with Mary Lacity, Wilcocks found another critical factor in successful outsourcing relationships is a focus on continuous improvement. As technology and business environments rapidly evolve, outsourcing relationships must also adapt and evolve to remain effective. Both the client and provider need to be proactive in identifying opportunities for improvement and innovation and work collaboratively to implement changes that drive value and enhance performance. This may involve regular reviews of the outsourcing arrangement, ongoing monitoring of service levels, and the incorporation of new technologies or processes that can streamline operations and improve outcomes. By prioritizing continuous improvement and innovation, outsourcing relationships can achieve long-term success and deliver sustainable value for both parties. In the same research, Lacity and Wilcocks also found these proven practices contributed to positive outsourcing outcomes: contractual governance, relational governance, client-retained capabilities, and provider capabilities.

Kate Vitasek's pioneering research at the University of Tennessee studied some of the world's most successful outsourcing relationships across many different areas, including business process outsourcing, logistics, construction, food manufacturing, environmental cleanup and staffing. The research project, funded by the United States Air Force, delved deeply into the contributing factors that surround very successful outsourcing relationships.

Not surprisingly, Vitasek and the rest of the research team found that one of the most important factors explaining success was a radical collaborative approach researchers referred to as a what's-in-it-for-we mindset (WIIFWe). The WIIFWe mindset is based on creating social norms with high degrees of trust, transparency and compatibility between the buyer and service provider.

Advice to Practitioners: To establish trust in outsourcing relationships, it is essential to be transparent and communicate effectively with the supplier, set clear expectations, and recognize the supplier's efforts and contributions. Additionally, building trust requires a long-term perspective and a willingness to invest time and resources in the relationship, as it is not a one-time effort. Research has proven that establishing trust makes a tangible financial difference in outsourcing relationships. It takes work, but it is worth it! Also of importance is the finding by Wilcocks that governance is critical to outsourcing success, a finding that is strongly supported by the Vested methodology.

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[8] L. Willcocks, S. Cullen, The Outsourcing Enterprise 2: The Power of Relationships. LogicaCMG, London (2005).

John W. Henke Jr. and Chun Zhang: Increasing Supplier Trust and Innovation

Over a six-year period, Henke, a professor of Marketing in the School of Business Administration at Oakland University (Rochester, MI), and Zhang, an assistant professor at the University of Vermont, analyzed the working relationships between 37 companies and their suppliers in five manufacturing and service industries. Their goal was to study supplier innovation behavior and to learn how companies can encourage suppliers increasingly to invest in innovative technologies and to share those technologies. This research, which was presented in a paper, "Increasing Supplier-Driven Innovation"[9] for the MIT Sloan Management Review, focused on the North American automotive industry.

The tricky question that most if not all companies face on a constant basis is how to get their suppliers fully engaged and committed to—and even be instrumental in driving—innovation. While the importance of innovation is a given that dates back more than 50 years to the teachings of Peter Drucker in The Practice of Management (1954), it has only been fairly recently that academics and organizations have been studying how to make innovation go from idea to reality.

The basic question Henke and Zhang addressed was: how can a customer effectively collaborate with a supplier more, while competing with it less in order to increase the supplier's innovation related activities. And related to that question—even if there are ways that suppliers might transfer innovation to their customers, how does one get them to do so? The key is trust and forging highly collaborative relationships. "Customer activities that are collaborative tend to build trust and subsequently foster supplier innovation transfer," Henke and Zhang wrote.

But the problem that can and often emerges is that there is a "competitive side" to collaboration, and "competitive activities in every customer/supplier relationship that result in distrust, which negatively affects such transfers." Take, for example, a case where a company and its supplier work together to provide a high-quality product—which strengthens mutual trust—only to see that trust come under stress when the company asks the supplier for price reductions.

"It is this relational stress and its accompanying distrust that cause suppliers to limit the extent to which they will transfer innovations to the customer."

So how do we reduce or eliminate this "relational stress" and make the leap to high collaboration, trust and innovation? Henke and Zhang identified three areas of collaborative activities, which they call the "Increasing Supplier Innovation Model," that a company can take to mitigate supplier stress and increase supplier innovation activities:

- Involve suppliers in the company's processes, especially product development
- Demonstrate openness and share information in a timely manner
- Work with suppliers to help them improve their competitiveness in both cost and quality

In other words, don't insist on innovation and then browbeat the supplier on costs!

"Trust in the relationship is especially important to the supplier, and that trust must originate with the customer," say Henke and Zhang. That's because it is the supplier that is at the greatest risk, especially in taking the initial steps of sharing propriety information, for example.

Advice to Practitioners: It works both ways, of course – the company must also trust the supplier. If the company gains access to the proprietary knowledge of one of its competitors through a mutual supplier, it will probably be difficult to trust that supplier with its own proprietary information. Henke and Zhang take a very Vested stance by stressing the importance of win-win collaboration and maximizing alignment with innovative suppliers.

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[9] https://sloanreview.mit.edu/article/increasing-supplier-driven-innovation/

Cynthia Rabe: Innovation and Zero-Gravity Thinkers

Cynthia Barton Rabe, best-selling author of ***The Innovation Killer***[10]*, passed away in 2011, killed by a hit and run driver at age 47 – just five years after her revolutionary book on innovation was published. If companies are in an innovator's dilemma, Rabe would tell you it's their own darn fault. Why? They are (literally) killing their own good ideas.*

But why would employees kill their own good ideas? For starters, let's face reality; innovation is difficult. How do you get from the universal desire for innovation to the reality of it? How do you create and nurture a culture that encourages innovation and makes it an essential lifeblood of a company? Rabe's lesson? Try some Zero-Gravity Thinking. But more on that in a moment.

Rabe challenged businesses to think differently about the nature of innovation. Her premise in The Innovation Killer is illustrative: We are "our own worst enemy" because the "burden of what we know limits what we can imagine." Her idea is that "groupthink" and "expertThink," along with knowledge and experience, are innovation killers. According to Rabe, the power of non-expert thinking can be a catalyst for real innovation because it disrupts the usual "group thinking" that often is too cautious, stifles creativity and derails the innovative solution.

First, Rabe defines innovation as "the application of an idea that results in a valuable improvement." Note the importance of value in that idea. Her definition is purposefully simple: "The point of the definition is to emphasize that the ability to think innovatively should be a goal for every function in an organization—not just the new product or technology development team."

Aha! Get everyone involved in the innovative process, not just the so-called experts. But unfortunately, Rabe's book is also based on the premise "that our ability to think innovatively within each and every function in an organization is under attack. And the attack isn't coming from the outside. It's coming from within. Perhaps most startling is that the threat increases as our companies become more successful."

Rabe contends there is "a wealth of evidence to suggest that both of these behaviors are nearly inevitable in organizations." "Together these behaviors weigh us down in 'what everyone knows': crushing new ideas, stifling breakthroughs, and, yes, killing innovation before it even surfaces."

Rabe's solution is straightforward and elegant: eliminate the organizational filters and processes that do the killing. "Our filters help us get a little better at what we already do but act as formidable barriers to doing something a whole lot better or even completely differently."

The novice or the non-expert can bring outside-the-box thinking to innovation, and even induce the experts to think about things in ways they never had before. These are what Rabe terms the Zero-Gravity Thinkers, because they are not weighed down by groupthink and expertThink. They can help organizations combine the power of the intuitive mind with the power of the expert mind.

Or as Rabe says regarding her experiences at Intel, Eveready Battery Company and others, "The prolonged presence of an outsider, who was not weighed down by the conventions of expertise, acted as a hyper-stimulant for creative ideas that could actually be implemented. Filters became less constrained. A different perspective suggested alternate paths. Innovative thinking flourished."

Advice to Practitioners: This is why Rabe's insights are so valuable in the Vested collaborative, "what's-in-it-for-we" mindset because Vested creates an ecosystem where zero-gravity – rather than zero-sum – Innovation can flourish. Rabe's research also highlights another piece of the Vested approach, the 'Standing Neutral' who acts as a proactive guide to keep the parties to an agreement on track.

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[10] https://www.amazon.com/Innovation-Killer-Limits-Imagine-Companies/dp/0814408834/ref=tmm_hrd_swatch_0?_encoding=UTF8&qid=1673645571&sr=8-3

Kathleen Eisenhardt: Rules to Thrive in a Complex World

Kathleen Eisenhardt, Professor of Strategy and Organization at the Stanford University School of Engineering, is best known for her influential and highly cited research in the area known as "agency theory."

In a 1989 paper, "Agency Theory: An Assessment and Review," published in the Academy of Management Review. According to Eisenhardt, agency theory considers the optimal contract form for the control relationship in which one person, the principal, delegates work to another, the agent. Eisenhardt concluded that agency theory offers a flexible approach to "control variables" by linking reward structures, "task characteristics, information systems, and business uncertainty" to behavior and outcome-based strategy.

As a fan of outcome-based contracting, her advice is that principals and agents (a buyer and seller) need to be on the same page regarding risk and risk sharing, pricing, incentives and communication. This is where the Five Rules of Vested – the foundation of the Vested business model – converges with the ideas of Eisenhardt on agency theory and provide a pathway to successful strategic interaction.

While Eisenhardt's work on agency theory is important, even more exciting is her latest research on applying "simple rules" for working in today's dynamic and complex world. She recently expanded on her influential 2012 Harvard Business Review article, "Simple Rules for a Complex World," in a book (with co-author Donald Sull) titled ***Simple Rules: How to Thrive in a Complex World***.[11]

Let's look at her research to learn why you should care. Eisenhardt's research led to a surprising discovery as she and Sull studied why some high-tech companies thrived during the internet boom. The finding? Companies like Intel and Cisco relied not on complicated frameworks - but on simple rules of thumb - even though they were in extraordinarily complex, challenging, and fast-moving industries.

Managers identified and focused on a critical process, such as acquisitions or capital allocation, where a bottleneck impeded growth. They then developed a few guidelines to manage that particular process. She explains why simple rules of thumb work so well. "This approach (using simple rules of thumb) helped companies to bridge the gap between strategy and execution—to make on-the-spot decisions and adapt to rapidly changing circumstances while keeping the big picture in mind."

Eisenhardt offers up these five rules as advice for developing "simple rules":

1. Identify a bottleneck that is both specific and strategic – the bottleneck should be relatively narrow, a well-defined process or process step, not a broad aspiration
2. Let data trump opinion – don't come up with wild, shoot from the hip rules; base them on a thoughtful analysis of historical experience
3. Users make the rules – don't hand down rules from above, let those involved in implementing the rules develop them
4. The rules should be concrete – they should not be difficult to understand; think yes-or-no criteria
5. The rules should evolve – simple rules should change as the company and the market change, and as managers better understand what is actually happening on the ground

Eisenhardt's current research centers on collaboration and competition in the computing, telecommunications, and semiconductor industries, from the perspectives of complexity, evolutionary, and game theories – that too much structure can create gridlock, while too little structure creates chaos.

Advice to Practitioners: When dealing with risk, incentives, sudden events, uncertain markets and volatile economic conditions – "structured chaos" in Eisenhardt's words – it's good to have some flexible and simple rules as a guide to fall back on. Even better, using the Vested approach, bake those simple rules into the agreement between the parties.

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[11] https://www.amazon.com/Simple-Rules-Thrive-Complex-World/dp/0544705203/ref=tmm_pap_swatch_0?_encoding=UTF8&qid=1673646611&sr=8-1

Jeffrey Pfeffer: The Relationship Between Power and Trust

Jeffrey Pfeffer (born July 23, 1946, St. Louis, Missouri) is an American business theorist and is the Thomas D. Dee II Professor of Organizational Behavior at Stanford Graduate School of Business where he has taught since 1979. He is the author or co-author of 15 books on the subject of Power, including “Power: Why Some People Have It—and Others Don’t”; “Managing With Power: Politics and Influence in Organizations” and “Power in Organizations”.

The work of Jeffrey Pfeffer is of interest to sourcing professionals because he has researched in the area of Power, Trust and the impact this has on contractual relationships. His research has found that the distribution (and use) of power can have a significant impact on the level of trust that exists in a contractual relationship. If there is a strong imbalance and the stronger party exercises that power, then the resulting lack of trust can undermine the effectiveness of the contractual relationship. Pfeffer’s solution to these issues are strategies that focus on transparency and communication so that trust is not diminished and the more powerful party comes to understand the negative aspects of their use of power.

Pfeffer also investigated the role of information asymmetry in contractual relationships. He found that the existence of information asymmetry can create power imbalances, particularly where one party has access to critical information that is germane to the contractual activity that the other party does not. The danger Pfeffer identified was that in these cases of information asymmetry can lead to unethical behavior. The temptation to exchange misleading or incomplete information with the less knowledgeable party to gain advantages in the contractual negotiations may prove too tempting. Again, the strategies of transparency and communication will provide benefits in overcoming the issues of information asymmetry.

The final area of Pfeffer’s research aligns nicely with that of Oliver Hart, the Nobel Prize winning economist, who introduced us to the concept of ‘Shading’ (see Page 36 for more discussion of Shading). Hart’s research in the area of Behavioral Economics found that when a supplier felt aggrieved because their expectations for the agreement had not been met they were likely to take action to limit their loss or punish the powerful customer. Researching in the area of Business Theory, Pfeffer came to very similar findings. His view was that there was a relationship between power imbalances and conflict in contractual relationships. He argues that power imbalances can lead to the use of coercive tactics to secure contractual commitments. This can then lead to conflict or shading as Hart calls it, to the detriment of both parties to the agreement.

Overall, Jeffrey Pfeffer's research has significantly contributed to our understanding of power dynamics in contractual relationships. His work has helped to identify key factors that can influence the distribution of power in contractual relationships, including the relationship between power and trust, the role of information asymmetry, and the relationship between power and conflict. The work he has carried out as a Business Theorist meshes well with the findings from other areas of research such as Behavioral Economics. His research has also helped to develop new strategies for managing power imbalances in contractual relationships and has helped to raise awareness of the importance of considering power dynamics in contract design and management

Advice to Practitioners: Sourcing professionals should ensure they consider power dynamics when setting up a contract. This is important whether your organization has power or not. By bringing into the open the existence of power imbalances or information asymmetry the parties are in a position to craft an arrangement that considers this aspect of their relationship and reach agreement on how it is to be managed. One way that the Vested methodology seeks to manage this is by having ‘Mutually Desired Outcomes’ that form a key part of how the parties will align their interests and focus on creating value for both.

Elvira Uyarra and Anne Rainville: Innovation in Public Procurement

Elvira Uyarra is Professor of Innovation Studies at Alliance Manchester Business School (University of Manchester), where she is also Executive Director of the Manchester Institute of Innovation Research. Anne Rainville is an Assistant Professor at the Copernicus Institute of Sustainable Development, Utrecht University. She studies the dynamic interplay between governments and markets and how the demand side can be leveraged to trigger and steer innovation.

Governments around the world are becoming increasingly concerned about the lack of innovation in procurement activities. In response to this issue, many jurisdictions have implemented legislation that seeks to promote the engagement of suppliers with innovation during the contracting and delivery process. However, despite the desire to obtain more innovation, this has not always translated into tangible outcomes. Professors Elvira Uyarra and Anne Rainville have both studied the reasons for this failure and have suggested potential solutions.

Elvira Uyarra has extensively researched the innovation processes and policies of various countries and regions. Her work has highlighted that public procurement policies are often disconnected from broader innovation policies, resulting in a lack of coherence and coordination. Furthermore, Uyarra notes that the traditional procurement process may not be well-suited to encouraging innovation, as it often prioritises price and technical specifications over innovative solutions. This can result in a situation where both suppliers and risk-averse government procurement staff are disincentivised from engaging in innovative practices.

To address these issues, Uyarra suggests that public procurement policies should be more closely aligned with broader innovation policies, with a greater emphasis on creating an environment that is conducive to innovation. This could involve incorporating innovation metrics into procurement evaluations, providing training and support for suppliers on innovative practices, and facilitating collaboration between suppliers and research institutions.

Meanwhile, Anne Rainville has studied the dynamic interplay between governments and markets, with a particular focus on how demand-side policies can trigger and steer innovation. Her research has highlighted that while demand-side policies such as public procurement can play a critical role in driving innovation, they must be designed and implemented carefully in order to be effective. Rainville notes that one of the key challenges with demand-side policies is ensuring that they are able to effectively target and incentivise innovation. To do this, she suggests that procurement policies should be designed with a greater focus on outcomes rather than inputs. This could involve specifying desired outcomes and leaving the methods and technologies used to achieve them up to the supplier, which can encourage greater innovation.

In addition, Rainville suggests that demand-side policies should be implemented in a way that allows for experimentation and learning. This could involve piloting new policies or approaches on a small scale before scaling them up or using mechanisms such as challenge-based procurement (similar to a Request For Information approach to market) to encourage innovation in a targeted area.

Advice to Practitioners: The research by Uyarra and Rainville resonates with the findings of researchers at the University of Tennessee. Those organisations seeking innovation need to tailor their approach to the market so that it does not disincentivise suppliers. By using the Vested approach, buyers will focus on outcomes and, importantly, leave the **How** to the supplier, thus leaving room for innovation.

PART TWO:

The Economics of Commerce

The classical economic approach to contracting focuses on the economic incentives of the parties. As such, the majority of research into classical economic theory emphasizes the role of material incentives, the assumption being that humans are egoistic and will always act in their self-interest. Under this assumption, conflicts of interest will inevitably arise, creating a risk for inefficiencies among trading partners and in the market as a whole. Where and how will these inefficiencies arise, and how can they be mitigated or avoided? These are some of the fundamental questions in economic theory, not least theories focused on contracts.

We start with the foundational work of Adam Smith, but we quickly move into the 20th century and focus on three pioneering theories centered on the economic side of contracting: contract theory, new institutional economics, and repeated game theory. We also profile the pioneers in behavioral economics – which studies not how humans should act if they were only thinking about their self-interests, but how they do act.

Ultimately, this section of the paper will help you understand the richness and diversity of economic thought as it relates to outsourcing and the procurement process. Through the insights of these economists, we hope you will gain a deeper appreciation for the complexities of economic exchange and the challenges of crafting agreements and relationships that promote prosperity and human well-being.

Adam Smith: Do What You Do Best

Adam Smith FRSA (baptized 16 June 1723 – 17 July 1790) was a Scottish philosopher and economist long before that term was first used, he was a pioneer in the thinking of political economy and key figure during the Scottish Enlightenment. Seen by some as "The Father of Economics" or "The Father of Capitalism", he wrote two classic works, The Theory of Moral Sentiments (1759) and An Inquiry into the Nature and Causes of the Wealth of Nations (1776). The latter, often abbreviated as The Wealth of Nations, is considered his magnum opus and the first modern work that treats economics as a comprehensive system and as an academic discipline.

How could we not start the section on the contributions that economists have made to Sourcing Theory with Adam Smith! So, what does Adam Smith tell us about outsourcing? The answer is somewhat complicated: Nothing directly, but then again, everything. Like the term 'capitalism', 'outsourcing' was not in use during Smith's lifetime. However, the idea existed in one form or another as markets and transactions developed and became more sophisticated. For example, when an entrepreneur formed a relationship with a guild of weavers to manufacture and sell garments, the marketing, distribution and manufacturing mixed mutual outsource relationships; all of the parties used their unique skills to do what they do best for mutual benefit.

Smith, a somewhat eccentric Scottish academician at Glasgow University, observed humans' propensity for self-interest and formulated the law of supply and demand in 1776 with the publication of An Enquiry into the Nature and Causes of the Wealth of Nations. He wrote that society benefits as a whole from a variety of trading transactions because humans will naturally seek what is best for them, resulting in fairness and honesty among equals. That was his theory, anyway. As demand for repeat transactions emerged, trading preferences evolved, and modern transaction-based business models developed. These transaction-based business models have been a cornerstone of conventional business relationships ever since.

Smith outlined a basic theory of international trade: "If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry employed in a way in which we have some advantage." Today, if one were to substitute "company" for "foreign country" in the quote above you would have the basic idea behind outsourcing. Put another way, what Smith said sounds very similar to what Tom Peters and Peter Drucker famously said over 200 years later, "Do what you do best and outsource the rest!"[12]

Lionel Frost, an associate professor in the department of economics and on the faculty of business and economics at Monash University, has written that Smith "would have approved" of today's outsourcing trends in terms of specialization and the division of labor across global markets. "While Smith would acknowledge that some people are affected adversely by outsourcing, he would conclude that on balance, society is better off when people are free to pursue the opportunities that the market presents," Frost says. "As Smith wrote, while widening the market is usually of general benefit, restricting competition and trade 'must always be against' the best interests of society." [13]

Advice to Practitioners: One of Smith's key points relates to specialization and this is a key reason that organizations outsource. In doing so they seek to use the skills and knowledge of a company that specializes in the activity being outsourced. For example, utilizing a Global Facilities Management business or a leading Third-Party Logistics provider. The danger comes when the outsourcing organization then proceeds to tell the service provider how to do their job via a comprehensive Scope of Works. Under the Vested approach we focus on Outcomes, the WHAT, not a detailed SOW and leave the HOW to the expert supplier or service provider.

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[12] The quote is widely attributed to both men. It is unclear who said it first, but likely Peters did in I*n Search of Excellence* (New York: Harper & Row, 1982).
[13] Ibid.

Ronald Coase: Business as a Math Problem

Ronald Coase (1910-2013), was a British-born American economist and the Clifton R. Musser Professor Emeritus of Economics at the University of Chicago Law School. He was awarded the Nobel Prize in Economics in 1991 for his pioneering work on ***The Nature of the Firm*** *and foundational underpinnings of transaction cost economics.*

Ronald Coase is perhaps best known for two articles. The first, "The Nature of the Firm" (1937), and the "The Problem of Social Cost" (1960). Coase work shed much-needed light on a concept known as transaction costs. Coase's breakthroughs showed that traditional basic microeconomic theory was incomplete because it only included production and transportation costs while neglecting the costs of entering into and executing contracts and managing organizations. Transaction costs – which are often hidden costs - account for a major share of the total use of resources in the economy.

Coase showed that every given distribution of property rights among individuals tends to be reallocated through contracts if it is to the mutual advantage of the parties and not prevented by transaction costs, and that institutional arrangements other than contracts emerge if they imply lower transaction costs.

Coase's big thinking earned him a Nobel Prize in Economic Science in 1991 for business as a math problem. This seems fairly obvious today but was pretty far reaching in 1930s when Coase penned his first article.

"Traditional theory had not embodied all of the restrictions which bind the allocations of economic agents," the Royal Academy explained when he received the Nobel Prize in 1991. "When transaction costs are taken into account, it turns out that the existence of firms, different corporate forms, variations in contract arrangements, the structure of the financial system and even fundamental features of the legal system can be given relatively simple explanations. By incorporating different types of transaction costs, Coase paved the way for a systematic analysis of institutions in the economic system and their significance."

Coase's work has led to the intense examination of the contract relations that characterize firms. His work became the basis for rapidly expanding research on principal-agent relations and also "influenced vital aspects of financial economics, such as the lively research devoted to explaining the pattern of financial intermediaries."

In his Nobel Prize lecture[14], Coase said: "Businessmen in deciding on their ways of doing business and on what to produce have to take into account transaction costs. If the costs of making an exchange are greater than the gains which that exchange would bring, that exchange would not take place and the greater production that would flow from specialization would not be realized. In this way, transaction costs affect not only contractual arrangements but also what goods and services are produced."

Ignoring transaction costs "leaves many aspects of the working of the economic system unexplained," Coase said, including the emergence of the firm, but much else besides. In fact, a large part of what we think of as economic activity is designed to accomplish what high transaction costs would otherwise prevent or to reduce transaction costs so that individuals can freely negotiate."

Advice to Practitioners: Coase's work is foundational to how organizations think about make vs. buy decisions – especially when it comes to outsourcing. The bottom line is that organizations that only think about price – and not total costs – can easily find themselves making suboptimal decisions. Today's sourcing professionals need to incorporate Total Cost of Ownership (TCO) and Best Value approaches. To learn more, download a free white paper from the University of Tennessee – Unpacking Best Value.

[14] https://www.nobelprize.org/prizes/economic-sciences/1991/coase/lecture/

Oliver Williamson: Transaction Cost Economics

Oliver Williamson, Professor emeritus of business, economics and law at the University of California, Berkeley, has spent his life devoted to the study of what is known in the world of academia as Transaction Cost Economics or TCE for short.. In October 2009 Dr. Williamson received the Nobel Prize for his analysis of economic governance, especially the boundaries of the firm. This work has significant implications for the outsourcing and supply chain management community.

Williamson focused on how businesses can be organized to best manage transaction costs. Specifically, Williamson dug into when it is better to pursue a "make-decision" and organize and manage the business with employees (vertical integration), versus when is it better to pursue a "buy-decision" and contract with external commercial parties. According to Williamson, the choice is very much a question of how a business optimizes its transaction costs.

Williamson believed that a contract is a tool for managing economic activities and that different forms of contracts or governance models can minimize transaction costs. To achieve the most efficient governance model, Williamson emphasized that businesses must consider the factors that affect transaction costs, which include relationship-specific assets, uncertainty, and frequency.

When relationship-specific assets generate dependency, it creates opportunities for hold-ups and abuse of power, leading to conflicts of interest and high transaction costs. Uncertainty and complexity in the business environment also contribute to transaction costs. Therefore, Williamson suggested that businesses choose a contracting structure that deals with potential changes during the contract term in the most efficient way.

To optimize for commodity-based discrete or transactional contracts, Williamson recommended using the market as a governance mechanism. However, for relationships with mid-level relationship-specific assets, uncertainty, and frequency, he advocated for hybrid (relational contract) approach. For high-level relationship-specific investments and high uncertainty and frequency, vertical integration (i.e., make) was his recommended approach.

Although vertical integration may appear to be the most efficient governance form, Williamson cautioned that there are hidden transaction costs associated with performing work that is noncore to the organization. In such cases, outsourcing noncore services is recommended. Williamson's work can be summarized as follows: use simple transactional contracts for high certainty, low complexity, low dependency situations, and use vertical integration where there are high dependency, high complexity, and considerable uncertainty. However, recognize that many situations call for a hybrid (relational contract) approach.

Williamson's research on transaction costs has helped businesses make informed decisions about organizing themselves to minimize transaction costs. By understanding the factors that affect transaction costs, businesses can choose the most efficient governance model for their particular situation. This can lead to better decision-making, improved coordination between parties, and ultimately, higher profits

Williamson's work can be summarized with a simple rule of thumb: Use simple transactional contracts for high certainty, low complexity, low dependency situations. However, use vertical integration where there are high dependency, high complexity, and considerable uncertainty. However, recognize there are many situations where a hybrid (relational contract) will be the optimal approach.

Advice to Practitioners: Deciding to insource or outsource is rarely a yes or no decision. Most often the decision will encompass a tradeoff between safeguards and price, and a “hybrid” highly collaborative partnership is the best approach. When developing business relationships and supporting contracts, it is important to decrease your transaction costs, and in turn, increase the profits generated by the relationship). The work of Oliver Williamson underpins much of the Vested Methodology and its focus on creating increased value for both parties.

Akerlof and Shiller: The Free Market Giveth, and It Taketh Away

The "invisible hand" of the market could be giving you a sharp slap more often than not, according to the Nobel laureates George A. Akerlof and Robert J. Shiller. Akerlof is University Professor at Georgetown University and received the 2001 Nobel Prize; Shiller is Sterling Professor of Economics at Yale University, and the winner of the 2013 Nobel Prize.

If you sometimes wonder whether markets always act in your best interest—or if that is even possible given the current state of capitalism—you're not alone. In their latest and aptly titled book, ***Phishing for Phools***[15], Akerlof and Shiller argue that as long as there is profit to be made, sellers will systematically exploit our psychological weaknesses and our ignorance through manipulation and deception. Rather than being essentially benign and always creating the greater good, as posited by Adam Smith, markets are inherently filled with trickery and traps; they'll "phish" us as "phools."

The book's premise! The free market isn't just the best mechanism to provide people with what they want; it is also the best mechanism to provide people with what they don't want. As Shiller said in a TED talk, "We need a free market economy, but it brings with it tons and tons of misleading behavior."

Why phish and phool? Reflecting his interest in behavioral economics, Shiller notes that phishing, which we see every day in our emails for example, is "any kind of deception that happens in our lives," while the "phool is someone that doesn't know he or she is being phished." Akerlof defines a phool as someone who might make a perfectly intelligent decision that happens to be a mistake. This is especially evident in financial markets: a kind of "economic equilibrium" occurs where well-meaning people find it difficult not to phish, "you kind of have to do it because everyone else is doing it," Shiller says.

He expanded on that idea in a recent WSJ interview following the book's publication: "If businesses have a chance to profit by tempting us into making decisions that are good for them but bad for us, they will take it. They have just as powerful an incentive to provide us with what we don't want as to provide us with what we do want."

In the same interview Akerlof added, "We think that's how things [happened] in financial markets [before] the 2008 financial crisis." Financial lenders packaged subprime mortgage loans into complex and unsustainable financial instruments that looked good on paper, but that few could really understand, until they brought the market to its knees when the bubble burst.

But what does this mean for outsourcing and strategic business relationships? Information, transparency, alignment and "playing nice" are powerful counterbalances to the market's inherent perverse incentives, power plays and games that Akerlof and Shiller describe.

To avoid muscular power plays, buyers and suppliers should take care early on to align their interests and collaborate in order to avoid "buyer-seller remorse." As the market continually shows us, those with the power will use it if they can, so it's important to make sure everyone gets what they are paying for, and that they get the deal they thought they were getting when first entering the negotiation.

Advice to Practitioners: The Vested sourcing business model uses systems thinking to create a dynamic and flexible governance framework designed to maintain and safeguard a balanced, principled relationship—a "getting to we" relationship that creates and expands value for everyone. To counter the temptation for sellers to phish Vested uses aligned incentives that ensure the increased value that is created outweighs any gains through 'phishy business'. That kind of collaborative, win-win mindset will help avoid manipulation, deception and market "phoolishness."

[15] https://www.amazon.com/Phishing-Phools-Economics-Manipulation-Deception/dp/0691168318/ref=tmm_hrd_swatch_0?_encoding=UTF8&qid=1673901860&sr=8-1

Oliver Williamson and Oliver Hart – All Complex Contract are Incomplete

Oliver Eaton Williamson was an American economist, a professor at the University of California, Berkeley, and recipient of the 2009 Nobel Memorial Prize in Economic Sciences, which he shared with Elinor Ostrom. Oliver Simon D'Arcy Hart is a British-born American economist, currently the Lewis P. and Linda L. Geyser University Professor at Harvard University. Together with Bengt R. Holmström, he received the Nobel Memorial Prize in Economic Sciences in 2016

Oliver Williamson and Oliver Hart are two Nobel Prize-winning economists who have contributed significantly to the understanding of how contracts work in economic transactions. In particular, both have developed theories around the idea of the incompleteness of contracts, which refers to the notion that contracts can never fully capture all the contingencies that may arise in a transaction.

Oliver Williamson's theory of the incompleteness of contracts is based on the idea that economic transactions are inherently complex and uncertain, and that it is impossible to anticipate every possible contingency that may arise. In his view, contracts are only able to specify a limited set of outcomes, leaving many aspects of the transaction open to negotiation, interpretation, and adjustment. Williamson argues that this incompleteness of contracts creates a need for ongoing relationship-specific investments and adaptations to ensure that both parties are able to achieve their desired outcomes.

Williamson's theory is grounded in his observation of real-world economic transactions, particularly those involving long-term contracts and relationships. He notes that many contracts are only partially specified, leaving significant gaps and ambiguities that must be resolved through ongoing negotiation and communication. This can lead to significant transaction costs, as both parties must invest time and resources in clarifying the terms of the agreement and resolving disputes. However, Williamson argues that this ongoing negotiation and adaptation is necessary to ensure that the transaction remains viable over time and that both parties are able to achieve their desired outcomes.

Oliver Hart's theory of the incompleteness of contracts builds on Williamson's ideas but takes a more formal and mathematical approach. Hart argues that contracts are inherently incomplete because they cannot fully specify the incentives of the parties involved in the transaction. In particular, he also notes that contracts cannot anticipate every possible scenario or contingency, and that the parties involved may have conflicting or divergent interests that are difficult to fully align through contract terms alone.

To address this incompleteness, Hart introduces the concept of residual control rights, which refers to the decision-making authority that is not explicitly specified in the contract. According to Hart, residual control rights are critical because they allow the parties involved to adapt and adjust the terms of the agreement over time as new information emerges or circumstances change. By retaining residual control rights, both parties are able to participate in ongoing negotiations and adapt the transaction as necessary to ensure that their interests are aligned.

Hart's theory has important implications for the design of economic transactions, particularly those involving complex and uncertain situations. He argues that contracts should be designed to allocate residual control rights in a way that aligns the incentives of the parties involved and promotes ongoing collaboration and adaptation. In particular, Hart notes that contracts should be flexible enough to allow for ongoing negotiation and communication, and should provide a framework for resolving disputes and clarifying ambiguities as they arise.

Advice to Practitioners: It is important for outsourcers to face the reality that their contracts are going to be incomplete. Rather than fight this with ever more complex contract clauses they should invest in simple pre-agreed methodologies by which any unexpected contingencies will be handled in a way that is fair to both parties. This is a key aspect of the flexible approach that the Vested methodology takes to contract design.

Herbert Simon: "Economic Man" and "Bounded Rationality"

Herbert Simon was a long-time professor at Carnegie Mellon University and received the Nobel Prize in Economics in 1978. Simon's diverse research ranged across the fields of cognitive psychology, cognitive science, computer science, economics, management, philosophy of science, sociology, and political science; he helped lay the foundation for behavioral economists around the world. He died in 2001.

Simon explored the intersection of philosophy, science, politics, economics and a range of other fields and called into question the traditional idea that "economic man" acts rationally.

His pioneering work around "bounded rationality" was the start of what would lead to many budding economists who challenged the conventional approach to economics. In one of his most important works, "A Behavioral Model of Rational Choice,"[16] (1955), he wrote that "traditional economic theory postulates an "economic man," who, in the course of being "economic" is also "rational."

The assumption is that this person (the "economic man") has knowledge of the business environment, has an organized and stable system of preferences, and relevant computational skills. "Recent developments in economics, and particularly in the theory of the business firm, have raised great doubts as to whether this schematized model of economic man provides a suitable foundation on which to erect a theory – whether it be a theory of how firms do behave, or of how they 'should' rationally behave."

His conclusion? This notion of economic man "is in need of fairly drastic revision." The task, he continued, is to replace that assumption of "global rationality" with a kind of rational behavior "that is compatible with the access to information that are actually possessed by organisms, including man, in the kinds of environments in which such organisms exist."

The problem is that there are variables to behavior that psychologists still wrestle with. Simon says, "Actual human rationality-striving can at best be an extremely crude and simplified approximation to kind of global rationality that is implied, for example, by game theoretical models." He identified six elements that could be included in models of rational behavior:

1. A set of behavior alternatives (or choices or decisions)
2. A subset of behavior alternatives that the organization considers or perceives
3. The possible future state of affairs, or outcomes of choice
4. A pay-off function, representing value or utility
5. Information on which outcomes will actually occur if a particular alternative is chosen
6. Information as to the probability that a particular outcome will occur if a particular behavior alternative is chosen

Simon set the course and some precepts for rationality in decision-making that are as valid and thought-provoking today as they were when he first developed them. In the biographical portion of his Nobel Lecture, he said: "In the 'politics of science, … I have had two guiding principles - to work for the 'hardening' of the social sciences so that they will be better equipped with the tools they need for their difficult research tasks; and to work for close relations between natural scientists and social scientists so that they can jointly contribute their special knowledge and skills to those many complex questions of public policy that call for both kinds of wisdom."

Advice to Practitioners: This is the same kind of bridge that is needed today between business people that are seeking to outsource, and their lawyers and stakeholders. When it comes to writing strategic win-win contracts, parties should recognize they will, almost by default, suffer from "bounded rationality" and as such need to create more flexible relational contracts. They will then be able to create sustainable outsourcing deals that are both fair and flexible in nature as 'business happens'.

[16] https://www.jstor.org/stable/1884852

Dyer and Singh: The Relational View for Alliances and Alignment

Jeffrey Dyer is the Horace Pratt Beesley Professor of Global Strategy at the Marriott School at Brigham Young University. Harbir Singh is the Mack Professor of Management at the University of Pennsylvania's Wharton School in Philadelphia. They explored their concept in an academically dense, but very insightful paper in 1998 titled "The Relational View: Cooperative Strategy and Sources of Interorganizational Competitive Advantage."[17]

Relational view, while not particularly new in academic circles, is a concept whose time has definitely arrived for the business world, as companies strive to find ways to form lasting collaborative modern relationships that create and expand value.

In their paper, Dyer and Singh said that a firm's "critical resources may extend beyond firm boundaries." Those resources may be "embedded" in interfirm resources and routines and go a long way to explaining superior performance—and how profits are earned and preserved. They argued that "an increasingly important unit of analysis for understanding competitive advantage is the relationship between firms," and they identified four sources that provide competitive advantages when organizations work together:

- Relation-specific assets
- Knowledge-sharing routines
- Complementary resources/capabilities
- Effective governance.

Looking at each point briefly, Dyer and Singh wrote: "The greater the alliance partners' investment is in relation-specific assets, the greater the potential will be for relational rents." They define "relational rents" as profits that are jointly generated in an exchange relationship that cannot be generated by either firm in isolation "and can only be created through the joint idiosyncratic contributions of specific alliance partners."

With respect to the second point, Dyer and Singh explained that the greater the investment by the partners in knowledge-sharing routines, along with alignment of incentives that encourage transparency and reciprocity, the greater the potential for profits.

And on the third point, complementary resources/capabilities, they said that when the partners increase the proportion of their "synergy-sensitive resources" they increase the unique value of those resources, and thus the potential for profits.

Finally, when partners solidify and expand their ability to align transactions with governance frameworks—while minimizing transaction costs and maximizing value—they also increase the potential for the relationship's profits.

Dyer and Singh describe some very basic tenets about collaboration, creating and expanding value that are inherent in successful Vested win-win relationships. While densely written – the message is also clear: "a firm's market value will be determined by the quality of its partners or will be influenced by economic events that influence its partners." In other words, find the right partnership alignment, but also keep in mind that "business happens!"

Advice to Practitioners: There is no question that a business's critical resources do extend beyond the walls of its executive suite. In fact, in our current economic and business climate, combining critical resources across business platforms is a necessity. When you come right down to it, isn't that what collaborative outsourcing is all about? By structuring the agreement between the parties so that incentives are aligned, and both businesses gain from success, you will have two groups of smart people focused on growth and innovation.

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[17] https://www.jstor.org/stable/259056?origin=crossref

John Nash: It Pays to Play Win-Win

John F. Nash (1928-2015) was a Princeton University mathematician and game theorist. He published his theory of equilibrium in 1950, commonly called the "Nash Equilibrium."[18] *For this contribution, Nash received the Nobel Prize in economics in 1994, which he shared with John C. Harsanyi and Reinhard Selten.*

Nash's pioneering work laid the foundation for the modern science behind cooperation. A Nash Equilibrium is defined as a set of strategies, one for each player, such that no player has an incentive to unilaterally change his/her action. Players are in equilibrium if a change in strategy by any one of them would lead that player to earn less than if she remained with his/her current strategy. For games in which players randomize (mixed strategies), the expected or average payoff must be at least as large as that obtainable by any other strategy.

Simply stated, Nash demonstrated that by doing the math, companies that work together will discover that the sum of the parts can be better when combined effectively than if they work at cross-purposes. Another way to think about it: 1+1 = 3, 4, or even more. In short – it pays to collaborate where parties can win with a win-win thinking.

While you might not be familiar with Nash and his Equilibrium – you may have seen the movie ***A Beautiful Mind***, which is loosely based on the life of Nash. In the movie, there's a brief "bar scene" that captures in an entertaining nutshell his great breakthrough in the use of games – especially non-cooperative game situations – as a basis for understanding complicated economic issues.

In the scene Nash, portrayed by Russell Crowe, has a revelatory moment in a campus bar as he and his mates ponder the best ways to produce optimum results in their approach and pursuit of a beautiful blonde and her not-as-beautiful friends. He realized that Adam's Smith's premise of "the best result comes from everyone in a group doing what's best for themselves" was "incomplete" and needed revision. Nash's premise? "The best result comes from everyone in a group doing what's best both for themselves and the group."

Whether or not the bar scene really played out as portrayed in the movie, Nash is credited with introducing the distinction between cooperative games, in which binding agreements can be made, and non-cooperative games, where binding agreements are not feasible. He developed an equilibrium concept for non-cooperative games that later came to be called the Nash Equilibrium.

Nash's lesson is simple but profound: Playing a game cooperatively to achieve a mutual goal is always better than playing it with self-interest in mind. Working together towards a win-win strategy is always better than a win-lose strategy aimed at promoting self-interest. Using Game Theory to predict the outcome of economic interactions is an essential tool to achieve performance-based, win-win trading partners relationships.

Advice to Practitioners: Many procurement professionals operate under the mistaken belief that if something is good for the supplier it is by definition bad for them. Both sides can and do play this game to no one's advantage. A true win-win approach is not a contest, a game of one-upmanship or an abdication by one party. Sourcing under the collaborative Vested business model is a partnership with regular, frequent communication to manage the expectations of everyone as well as the work. Nash's work is essential because he showed the value of reaching equilibrium, or win-win solutions and outcomes in difficult scenarios, as the way to achieve successful business and outsourcing partnerships.

[18] https://www.cs.upc.edu/~ia/nash51.pdf

Oliver Williamson: Develop Contracts that create "Mutuality of Advantage."

Oliver Williamson is Professor emeritus of business, economics and law at the University of California, Berkeley. In October 2009 Dr. Williamson received the Nobel Prize for his analysis of economic governance, especially the boundaries of the firm. This work has significant implications for the outsourcing and supply chain management community.

Once a company has answered the make/buy decision, an organization must determine the strategy for working with its suppliers. Dr. Williamson cites fellow economist James Buchanan, who stated that the notion of economics as a 'science of contract' rather than as a 'science of choice' is underdeveloped. Buchanan's 2001 article ("Game Theory, Mathematics and Economics"[19] in the *Journal of Economic Methodology*) said, "Mutuality of advantage from voluntary exchange" is the most fundamental of all understandings in economics." A game in the context of outsourcing includes a set of companies, a set of moves (or strategies) available to those businesses, and details of the payoffs for each combination of strategies applied.

Dr. Williamson points to the power of win-win approaches, which in the realm of performance-based and Vested Outsourcing includes Game Theory, Behavioral Economics, Solutions concepts and the Non-Zero-Sum Game.

Win/Win / Game Theory thinking has grown in popularity among academics studying mathematics and economics. To date, eight Nobel Prizes have been awarded to Game Theorists, the first being John Nash in 1994 for his famous "Nash Equilibrium." Most practitioners have heard about win/win thinking; however, it is important to understand that win-win thinking is more than just a popular phrase saying that companies need to collaborate better. Win-win thinking should be a key strategy for companies. Most practitioners do not realize that droves of economists and mathematicians have simulated and strategically proven that agreeing to play a win-win game enables individuals and organizations to come out ahead.

In outsourcing, achieving equilibrium among the parties by committing to a win-win strategy through collaboration, flexibility and foresight can grow both organizations' businesses. As Nash demonstrated, the key lies in players working together toward a mutually beneficial strategy that optimizes for the cumulative payoff. The idea is not to optimize for the status quo, but to look for ways to change the game, or the contract process, to achieve a larger payoff for everyone.

The size of the pie is not fixed! Companies can and should work together to find ways to make more pie. By working together, they can identify opportunities to reduce costs and increase service.

Our research found that even when companies talked win-win they often still contracted under typical win-lose thinking. For example, we often hear business people talk about "collaboration" and the "long term" but their contracts would clearly spell out 30 or 90-day terms for convenience clauses. A panel of shippers described how important their carriers were to their success, yet none of these contracts lasted longer than a single year. That is like telling a five-year-old to sit still for an hour in order to get a treat. That's a strategy that won't work very well for the short or the long term.

Advice to Practitioners: Dr. Williamson helps to take the concept of game theory out of the land of economics and into the land of contracting. He shows that the contract itself can have negative impacts on the business if an organization does not think through how to structure and negotiate the contract properly. A properly structured contract can increase the profits for all, while a poorly structured contract simply divides the benefits – or even shrinks them. In short, don't just say win-win! Contract for win-win.

[19] https://www.tandfonline.com/doi/abs/10.1080/13501780010022802?journalCode=rjec20

Robert Axelrod: The Art of Playing Nice

Robert Axelrod, the Walgreen Professor for the Study of Human Understanding at the University of Michigan, developed what is known as cooperation theory and his book, ***The Evolution of Cooperation***[20] *(1984), popularized the study of cooperation.*

Another Game Theory pioneer, Axelrod verified that cooperation and "playing nice" in the business world, and for that matter in life, is the best and most successful way to operate. Axelrod demonstrated how cooperation can emerge, grow and persist by applying game theory and computer simulation solutions to a thought experiment, The Prisoner's Dilemma. He found that playing nice is the best strategy. And he did this with a computer contest he devised more than 50 years ago!

In the 1980s, Robert Axelrod, then a professor of political science and public policy at the University of Michigan, did something very unusual: he arranged two computer tournaments. Using gigantic computers that filled rooms back in the early 1960s, he showed there are circumstances in which even selfish people are inclined and induced to cooperate in difficult or hostile situations, and not betray others or retaliate, in order to achieve the best possible results. At these tournaments, software programs written by mathematicians, game theorists and others competed against each other to determine the best strategy for continuing cooperation. Some of the software programs submitted were collaborative, while others were defective, or trying to take advantage of and abuse others' willingness to collaborate.

The tournament rules were simple. All participating "players" (software programs) met each other in pairs. In each round, each player had one of two choices: to cooperate or defect. The game was structured as a prisoner's dilemma. In other words, the "prisoner" had to choose between cooperating and hoping that his cohort would also choose to cooperate with him for a long-term gain, or choose the self-interested strategy to defect. Defection only pays off if the other player cooperates. If both players defect, they both lose; short-term, self-interested pursuit of goals fails.

Axelrod's solution to the prisoner's dilemma, by the way, was elegant, simple and, well, really nice! It's based on the idea and the old adage that one good turn deserves another by intentionally avoiding oppositional behavior. His findings showed that the best tactics for "winning" are:

- Always return cooperation for cooperation
- Be fair with your partner
- Don't try to be tricky and game the system for your benefit

Using Game Theory to predict the outcome of economic interactions is an essential tool to achieve performance-based, win-win outsourcing arrangements.

Many companies that outsource operate under the mistaken belief that if something is good for the service provider it is by definition bad for them. Both sides can and do play this game to no one's advantage.

The lessons of Nash and Axelrod are simple but very profound: Playing a game cooperatively to achieve a mutual goal is always better than playing it with self-interest in mind. Working together towards a win-win strategy is always better than a win-lose strategy aimed at promoting self-interest.

Advice to Practitioners: A true win-win approach requires effort and commitment by all parties. It's not a contest, a game of one-upmanship or an abdication by one party. Outsourcing under a Vested approach is a partnership with regular, frequent communication to manage the expectations of everyone as well as the work. Nash's work was vital because he showed the value of reaching equilibrium, or win-win solutions and outcomes in difficult scenarios, as the way to achieve successful business and outsourcing partnerships. Axelrod's work proved Game Theory's essential point.

[20] https://www.amazon.com/Evolution-Cooperation-Robert-Axelrod/dp/0465021220/ref=tmm_hrd_swatch_0?_encoding=UTF8&qid=1673904402&sr=8-1

Stewart and Plotkin, the Prisoner's Dilemma and Generous Strategies

Alexander J. Stewart is an Assistant Professor in the Department of Biology and Biochemistry at the University of Houston. Joshua B. Plotkin is the Walter H. and Leonore C. Annenberg Professor of Natural Sciences at the University of Pennsylvania. In 2013, while both were at the University of Pennsylvania, they published "From Extortion to Generosity, Evolution in the Iterated Prisoner's Dilemma."[21]

Their findings shed a new light on a classic question concerning human behavior: Is it better to gain a lot at the expense of another person, or to gain slightly less while simultaneously promoting the other's wellbeing? They explore this question through the application of a spin on the classic Prisoner's Dilemma game. A Prisoner's Dilemma is a situation, common in society and business, where the short-term self-interest of each party conflicts with the parties' long-term interests. Research has shown that over the long term, people (or organizations) are better off if they cooperate.

The Stewart and Plotkin work is full of rather dense mathematical equations and Venn diagrams that looks at what they reference as "zero determinant (ZD) strategies." They write: "Recent work has uncovered a remarkable class of extortion strategies that provide one player a disproportionate payoff when facing an unwitting opponent." This is what is called the zero determinant (ZD) and is typified by a solution where one party "wins" at a much higher rate than the opponent. They identify ZD, as "a new class of probabilistic and conditional strategies" that unilaterally set the expected payoff of an opponent in iterated plays of the Prisoner's Dilemma no matter the opponent's strategy, or else determines the ratio between a ZD player's and their opponent's expected payoff.

While the math is impressive, it's their conclusion that is impressive. Simply put, they find (like all the other research!) that cooperation and generosity are better modes of behavior than obstinance and self-interest when it comes to thriving within a society.

While extortion strategies "perform very well in head-to-head competitions," at least for a brief period of time, Stewart and Plotkin write, "they fare poorly in large, evolving populations."

Common sense – right? What is maybe not so common sense is that Stewart and Plotkin look beyond ZD extortion strategies to something they refer to as "generous ZD strategies." The generous ZD strategy subset involves active cooperation with others and the forgiveness of defection, thus replacing the extortionists.

In general, Stewart and Plotkin continue, "Extortion and ZD strategies are disfavored by evolution in populations. This has led to the view that ZD strategies are of importance only in the setting of classical two-player game theory, and not in evolving populations."

Their conclusion: when the various Prisoner's Dilemma strategies are in play, generous strategies are "disproportionately favored" over extortion strategies. That's because they "stabilize cooperative behavior."

Stewart and Plotkin's results underscore the value of collaboration and cooperation—major tenets of the Vested model—and help explain the evolution of cooperation in the Prisoner's Dilemma scenario.

Advice to Practitioners: Be nice and cooperate and you will win much more often than not. Be generous and you will really win friends and influence others, which will come back in positive ways in the future. While some would call this good karma, others need the underlying math and science to prove common sense. We are thankful Stewart and Plotkin took the time to do the math and – yet once again – prove you can indeed win more with a "what's-in-it-for-we" (WIIFWe) mindset!

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[21] https://www.pnas.org/doi/pdf/10.1073/pnas.1306246110

Oliver Williamson: Build Trust: Leave Money on the Table.

Oliver Williamson is Professor emeritus of business, economics and law at the University of California, Berkeley. In October 2009 Dr. Williamson received the Nobel Prize for his analysis of economic governance, especially the boundaries of the firm. This work has significant implications for the outsourcing and supply chain management community.

Dr. Williamson took transaction cost analysis to an important new level with the concept of 'transaction cost economics' (TCE). TCE looks at the entire costs of doing business, including the contracting process, and at how organizations behave regarding the contract and how people behave during contract negotiations. His article[22] in the April 2008 Journal of Supply Chain Management examined outsourcing from the TCE perspective. Williamson states "all complex contracts will be incomplete–there will be gaps, errors, omissions and the like," and he advises that organizations shift to contracts that have a more flexible framework.

Dr. Williamson also states that TCE does not necessarily embrace "user-friendly" concepts such as the "elusive concept of trust." He wonders what benefits might come from the more widespread use of trust among outsourcing buyers, and at what cost. Trust should not necessarily supplant power entirely and indefinitely, he argues, and that is where the credible part of contracting comes in.

We would propose that the most effective and collaborative contracts, the truly credible ones, must include trust. The idea of vesting, or committing, one's self or a company in a contract arrangement implies substantial initial trust in the value of the enterprise, a large degree of give-and-take to achieve mutual goals and substantial good faith during the course of the relationship.

Trust is implicit in Dr. Williamson's suggestion that it's often better to leave money on the table, or not insist on winning every negotiating point. It's an idea that goes against the usual low-cost, transaction-based grain in a traditional contract.

In a new and potentially long-term arrangement, constructive and strategic contractual intentions are sometimes hard to differentiate. What exactly are the parties' intentions going into the negotiation?

If there is a strategic rather than constructive purpose that skews the contract in one party's favor "and if real or suspected strategic ploys invite replies in kind, then what could have been a successful give-and-take exchange could be compromised," Dr. Williamson explains.

If each party, or even one party, has a strategic agenda and wants to gain an upper hand – or go muscular – asymmetry will result. This "could plainly jeopardize the joint gains from a simpler and more assuredly constructive contractual relationship," he says.

"Always leaving money on the table can thus be interpreted as a signal of constructive intent to work cooperatively, thereby to assuage concerns over relentlessly calculative strategic behavior." What can result is a pragmatic and ultimately wise outsourcing contract with credibility from start to finish.

Advice to Practitioners: Leaving money on the table may sound foolish, but when striking a strong business relationship, it can signal a constructive intent to work cooperatively that will build an environment that is credible from start to finish. A large degree of give-and-take is required to achieve mutual goals. In longer term and complex agreements, the buyer may have an expectation that the supplier will invest in assets and capabilities to support their customer. By leaving money on the table buyers leave space, and money, for the supplier to make those investments.

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[22] Oliver E. Williamson, "Outsourcing: Transaction Cost Economics and Supply Chain Management," Journal of Supply Chain Management 44, no. 2 (2008): 5-16.

Kenneth Arrow: Trust's Central Role

Kenneth Joseph Arrow was an American economist, mathematician, writer, and political theorist. He was the joint winner of the Nobel Memorial Prize in Economic Sciences with John Hicks in 1972. In economics, he was a major figure in post-World War II neo-classical economic theory. Many of his former graduate students have gone on to win the Nobel Memorial Prize themselves. His most significant works are his contributions to social choice theory, notably "Arrow's impossibility theorem", and his work on general equilibrium analysis. He passed away in 2017.

Trust is not only a nice thing to have and foster, it has, as Arrow said back in 1974, a very important pragmatic value. "Trust is an important lubricant of a social system," he noted in a widely disseminated quote (cited for instance in Trust by Francis Fukuyama[23]). "It is extremely efficient; it saves a lot of trouble to have a fair degree of reliance upon other people's word."

Unfortunately, trust is not an easily purchased commodity. "If you have to buy it, you already have some doubts about what you've bought." Arrow says that trust and similar values such as loyalty and truth-telling are what an economist refers to as "externalities." They have practical economic value and they increase the value of the system, "by for example enabling you produce more goods or create more value for services."

But the problem as Arrow alludes to is that these externalities are not commodities in the traditional sense of open market trading. The confluence of markets and ethics needs special handling and consideration. "The market has deficiencies of a kind for which ethics is a remedy," Arrow wrote in a 2006 article, "The Economy of Trust." For example, he says the world is "filled with private information. There is inside information on products and in contracts. In these situations, there is a very strong possibility of one person using this information to take advantage of the other. If this happens frequently, a market may not exist at all because the buyers know that they don't know certain things, and that the sellers can exploit them."

"To get markets that work," he continues, "you have to keep the other person from trying to cheat you at every moment. So, morality is closely related to the workings of the market." Not only is morality closely related, he adds, it "plays a functional role in the operation of the economic system."

Arrow asks some pertinent (and uncomfortable) questions: "Could it be argued that a certain amount of virtue of a basic kind—being honest, honoring contracts, providing accurate information—is required for a market to work? Is it a danger that prosperity can sometimes weaken those virtues? To become prosperous, you need to be virtuous, but then does prosperity erode the foundations of virtue? I don't know if it's so much prosperity as the prospect of prosperity that's dangerous."

These are difficult questions to answer and terms that are difficult to define, which could be a reason why as Arrow says, "psychology is invading—the whole field of behavioral economics. I believe that sociology should play more of a role in economics than it does."

Very true. When was the last time you thought about the value of morals and ethics in the marketplace? Got you there, didn't I? Yes, they should play a functional role in our business relationships. I believe there is a shift occurring to this way of thinking, and the Vested collaborative approach to business partnerships, based on social norms of trust, integrity, honesty, transparency and reciprocity puts businesses on this more righteous path.

Advice to Practitioners: The Vested Outsourcing Manual calls for companies to create a joint Statement of Intent that includes an agreement on the behaviors that buyers and suppliers will mutually seek. Bottom line – you've got to start with ethics and trust as the foundational lubrication in order to have a successful collaborative business deal.

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[23] https://www.amazon.com/Trust-Social-Virtues-Creation-Prosperity/dp/0684825252

Oliver Hart: Contracts as Reference Points - Shading

Oliver Hart served as lecturer in economics at the University of Essex and other institutions before joining the faculty of the London School of Economics (LSE) as professor of economics in 1981. He was later professor and visiting professor of economics at the Massachusetts Institute of Technology (MIT) and LSE. He is currently the Lewis P. and Linda L. Geyser University Professor at Harvard University. Together with Bengt R. Holmström, he received the Nobel Memorial Prize in Economic Sciences in 2016

Behavioral contract theory, an approach in economics, integrates insights from psychology and behavioral economics to examine how contracts are created, why they may be incomplete, and how they can lead to inefficient decision-making. Oliver Hart, a key contributor to this theory, expanded his work on incomplete contracts and residual control rights in the 1990s. This work, along with research showing that people have a strong sense of fairness and a self-serving bias, led Hart to revisit his earlier work on contract theory in 2008 with John Moore. In doing so, he explored the reasons why people write contracts and the consequences of failed expectations.

Hart's earlier answer as to why contracts are written was from the view of an Econ (a term created by Richard Thaler to describe the economic ideal rather than a human), who argued that contracts were written to encourage investments and protect parties from each other's opportunistic behavior. However, Hart's latest research approach viewed the question from the perspective of a human, particularly focusing on the research showing that people tend to have a sense of fairness and a self-serving bias. A key finding was that while preventing the abuse of power to extract value may be an important reason for why contracts are written, an equally important reason is to avoid the problem of what Hart coined as 'shading.' Shading is a retaliatory behavior in which one party stops cooperating, ceases to be proactive, or makes countermoves because of a feeling of being unfairly treated by the other party.

Shading is a result of failed expectations from the deal, primarily when the other party is to blame for it. When two parties fail to communicate their expectations clearly, they run the risk of disappointing one another. A formal written contract can help to avoid this problem by making explicit and aligning expectations. However, just as writing contractual clauses can never completely prevent the risk of hold-up from occurring, the problem with failed expectations and shading cannot be completely avoided through the contract. The fact and problem that contracts are incomplete remain.

Hart's research on behavioral contract theory emphasizes the importance of considering human behavior when analyzing contract theory. Resulted in a Harvard Business Review Article, co-authored with David Frydlinger and Kate Vitasek titled ***'A New Approach to Contracts: How to build better long-term strategic partnerships'***. It suggests that people's sense of fairness and self-serving bias can impact the efficiency of decision-making and the success of contractual relationships. The theory emphasizes the need to create clear, formal contracts that align expectations and mitigate the risk of failed expectations leading to shading. While the theory recognizes that contracts will always be incomplete, it suggests that a focus on human behavior can lead to better-designed contracts that are more efficient and effective.

Advice to Practitioners: Practitioners should consider the insights from behavioral contract theory, which integrates economics with psychology and behavioral economics, to create better long-term strategic partnerships. By doing so they will avoid the pitfalls of shading and other negative impacts on the arrangements. By using the Vested approach, we seek to align incentives, use agreed intended behaviors and fair governance processes to achieve an agreement that should set the parties on a path where shading is unlikely to occur.

Douglass North: Institutions and Success

Douglass C. North, a professor at Washington University's Department of Economics in St. Louis, MO, has led groundbreaking work on how institutions and societies interact and how those interactions can positively or negatively impact economics over time as they evolve. North – a professor, economist, philosopher, and economic historian – was the co-recipient (with Robert Fogel) of the 1993 Nobel Prize in Economic Sciences "for having renewed research in economic history by applying economic theory and quantitative methods in order to explain economic and institutional change."

In a 1991 paper on institutions[24], North argues that institutions are "the humanly devised constraints that structure political, economic and social interaction. They consist of both informal constraints (sanctions, taboos, customs, traditions, and codes of conduct), and formal rules (constitutions, laws, property rights)." As an institution, these formal and informal behaviors have the power to "shape the direction towards growth, stagnation or decline."

A key premise of North's work is that institutions are needed to "create order and reduce uncertainty in exchange." Businesses eventually create a set of institutional norms and actions that drive the nature of the relationship, and in turn the economic value that follows from businesses doing business together.

The "rules of the game" are what determine if humans and organizations run into conflicting interests. Institutions without clear rules of the game are more likely to have conflicts that generate inefficient transaction costs. Distrust in the rules of the game and high transaction costs may be so high as to dis-incentivize institutions and individuals to not conduct business at all. North's work has been attributed to explaining the economic and political success or failure of entire nations. However, his insights are also crucial for every contracting professional. Why? A contracting professional's job is to set the contractual rules of the game and ultimately. affect the success or failure of the business relationship.

Formal rules are written laws and written contracts while informal rules are moral norms and habits around which no formal agreement exists. Together both informal and formal rules exist and together shape the incentives of the parties and the extent to which they run into costly conflicting interests. For North, the common denominator of the different kinds of rules is to coordinate actions, thus affecting transaction costs.

Viewing businesses as institutions mean that there are more than cold commercial calculations at work, because institutions, as North indicates, are also social arrangements. North examines this through a game theory lens: "Wealth-maximizing individuals will usually find it worthwhile to cooperate with other players when the play is repeated, when they possess complete information about the other player's past performance, and when there are small numbers of players. But turn the game upside down. Cooperation is difficult to sustain when the game is not repeated (or there is an endgame), when information on the other players is lacking, and when there are large numbers of players."

Bottom line –it's hard to build a highly cooperative business relationship when you don't trust the other party—when there's a win-lose "endgame" underway. Think about it. Which side do you want to be on in the face of a dynamic and risk-filled business world? Someone you can trust – or someone that is consistently opportunistic and will throw you under the bus in the face of adversity? North won a Nobel Prize in economic science for his work showing how the rules by which institutions play can have a substantial effect on transaction costs. Simply put, having sound rules can help organizations cooperate and avoid conflicting interests.

Advice to Practitioners: Be on the same side of the table with your customer (or supplier) solving the tough problems rather than sitting across the table negotiating in a never-ending battle of tradeoffs, concessions, and risk shifting. Treat business as a mathematical or optimization problem rather a series of tradeoffs.

[24] Douglass C. North, *The Journal of Economic Perspectives*, Vol. 5, No. 1. (Winter, 1991), pp. 97-112.

Oliver Williamson: Use a Contract as a Framework – Not a Legal Weapon

Oliver Williamson is Professor emeritus of business, economics and law at the University of California, Berkeley. In October 2009 Dr. Williamson received the Nobel Prize for his analysis of economic governance, especially the boundaries of the firm. This work has significant implications for the outsourcing and supply chain management community.

Recently deceased author and leading legal academic Ian Macneil was ahead of his time in 1968 when he professed that business-to-business contracts should be 'instruments for social cooperation'. Unfortunately, many companies' lawyers are creating outsourcing contracts so tightly defined with self-interested terms that their contracts are legal weapons instead of instruments of social cooperation.

Dr. Williamson advises that a contract should provide a flexible framework and a process for understanding and managing the parties' relationship as the business world changes.

If we stop and think about it – having a contract as a flexible framework makes perfect sense. All practitioners know that the world of business is not static; it changes and evolves. Dr. Williamson argues that organizations "need to come to terms both with bounds and rationality." He points out "all complex contracts will be incomplete – there will be gaps, errors, omissions and the like." And, as human actors, we are bounded by our inability to know everything. The contractual framework thus must be highly adjustable or adaptable rather than prescriptively outline the detailed working relations.

Our research found a common mistake that companies make in outsourcing today is that they create detailed statements of works (SOWs) and try to define too tightly the work to be done. Dr. Williamson advises that the contract should have "the effect of which is to facilitate adaptation, preserve continuity and realize mutual gain during contract implementation." Contracts should be structured with flexibility to deal with unexpected disturbances to relieve potential maladaptation's.

Research also shows that today's contracts are filled with self-interested terms designed to protect self-interest rather than promote social collaboration between companies. It is difficult to see how focusing on these terms will provide the framework needed to be adaptable in a changing environment. Instead, these terms, coupled with overly prescribed Statement of Works, create a rigid operating environment. When business does change (as it always does) the parties get uncomfortable, and tension arises and fingers are pointed. A better approach is to simply realize that the business environment can and will change and that companies need to address how to best mitigate the risk versus trying to shift risk.

What makes this more interesting is that using a contract as a legal weapon is done by choice not by law. "The distinguishing feature of contractual obligations (in business) is that they are not imposed by the law but undertaken by the parties', (Smith, 1993 as cited by Macneil). In other words, companies choose to design contracts with terms that defeat collaboration; they are not required by law to do otherwise. If we have chosen the contractual obligations, we are imposing on ourselves, shouldn't they be beneficial to everyone involved?

Creating a detailed contract and associated statement of work puts the outsource provider into a "box" and forces the provider to stay there under the contract. Likewise, using terms that promote self-interests further deteriorates the spirit of cooperation and collaboration by encouraging finger-pointing when the business environment can and does change.

Advice to Practitioners: Instead of being a prescriptive document, the contract should provide a flexible framework and process for understanding the parties' relationship. This means this framework/process must be highly adjustable or adaptable. However, in achieving this "flexible framework" the contract will never accurately indicate real working relations. Instead of trying to "guess" about the future, it is better to indicate a rough idea of the work to be done, and provide recourse for ultimate appeal.

Richard Thaler: Writing Contracts for Humans

Richard Thaler, Professor of Behavioral Science and Economics at the University of Chicago Booth School of Business, understands the "human" side of economics. He's a founding member of behavioral economics and most recently won the 2017 Nobel Prize in Economics Sciences. The Nobel committee credited Thaler with taking the behavioral field from the fringe to the academic mainstream. The Nobel committee said that by "exploring the consequences of limited rationality, social preferences, and lack of self-control, he has shown how these human traits systematically affect individual decisions as well as market outcomes."

Thaler has said the basic premise of his approach to economics is that, "In order to do good economics, you have to keep in mind that people are human." In a 2015 New York Times article, "Unless You Are Spock, Irrelevant Things Matter in Economic Behavior,[25]" Thaler wrote, "Supposedly irrelevant factors, or SIFs, matter a lot, and if we economists recognize their importance, we can do our jobs better. Behavioral economics is, to a large extent, standard economics that has been modified to incorporate SIFs."

That's a wonderful insight, but the trick is to sift through the factors that are relevant, possibly relevant, irrelevant and possibly irrelevant, while making the numbers make sense.

For those not familiar with Thaler and his work, his book ***Misbehaving: The Making of Behavioral Economics***, is a must read. In it he describes how behavioral economists challenged traditional thinking over the last forty years. His best-selling book ***Nudge*** (2008 - with Cass R. Sunstein) is also a great read that explores how behavioral economics can be used to tackle many of society's major problems.

Simply put, Thaler is instrumental in making economics more human.

David Frydlinger, a Swedish lawyer and partner in the Lindahl law firm, is an expert in relational contracts, says, "Thaler is of fundamental importance for those who wish to succeed in writing good contracts in a complex economy." "Humanizing" economics and contracts is a significant and much-needed development that the legal and contracting community should carefully follow, and why Thaler's work is so significant. So, how is this relevant to contracts? It matters a great deal whether we think of ourselves as Econs or Humans, both those who write contracts but also those on 'the other side.'

Econs will lie to get what they want and will take every chance to get a contract that gives them most of the power and completely regulates all the bad things that can happen. "If I think that I am an Econ, I will think that I in fact can write a watertight contract since I have unbounded rationality and can foresee everything," says Frydlinger.

But the problem is that everyone is human even if some think of themselves as utterly rational Econs. Humans have a strong sense of fairness and often punish those who treat them unfairly even if it is against their own best economic interest. So, treating Humans as if they Econs can lead to problems if they are sent a contract that is power-based, and shifts most of the risks to them.

By viewing ourselves and others as Econs instead of Humans when negotiating and writing contracts, we will generate many of the risks we think we mitigate when writing a contract. "There can be no doubt that this explains many of the reports of value leakage and other problems in many transactional contracts," Frydlinger notes.

Advice to Practitioners: There is a growing amount of research showing how and when relational contracts (Human) out-perform conventional transactional contracts (Econ) in terms of cost advantages, time, quality and innovation. Bottom line: it can be very costly to ignore Thaler's Nobel prize and write contracts as if we and the others are Econs instead of Humans.

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[25] https://www.nytimes.com/2015/05/10/upshot/unless-you-are-spock-irrelevant-things-matter-in-economic-behavior.html

Oliver Williamson: Style Matters – Be Credible.

Oliver Williamson is Professor emeritus of business, economics and law at the University of California, Berkeley. In October 2009 Dr. Williamson received the Nobel Prize for his analysis of economic governance, especially the boundaries of the firm. This work has significant implications for the outsourcing and supply chain management community.

Oliver Williamson identifies three styles of contracting in outsourcing services: **muscular**, **benign**, and **credible**. The muscular approach is where one party holds the balance of power and is not afraid to exercise it. This approach is deemed as "myopic and inefficient" as it can lead to suppliers being used up and discarded, which in turn can lead to higher overall costs. The benign approach, on the other hand, assumes that both parties will cooperate and give-and-take in the relationship. However, this approach does not work well in long-term agreements as it assumes too much trust and can lead to one party taking advantage of the other. This last point is supported by the field research conducted by the University of Tennessee which found multiple examples of gain sharing that was brought undone by one party taking advantage of the other.

Williamson recommends companies use a third approach, which he calls a credible contracting approach. This approach is hardheaded and wise as it strives for clear results and accountability while not being mean-spirited. It recognizes that complex contracts are incomplete and require feasible foresight to uncover potential hazards and work out mechanisms to mitigate them. Credible commitments should be introduced to effect hazard mitigation.

Contract safeguards can take unconventional forms, as discussed by Williamson regarding ancient Mesopotamia, where self-inflicted curses were used to deter breaches of treaties. The key point is that a good hybrid contract for a complex outsourced service will be above all fair and equitable to both parties in the agreement, and it will challenge the organizations to focus energy on unlocking inefficiencies rather than negotiating for the win at the other party's expense.

In some cases, companies using the muscular approach have ended up bankrupting their suppliers or scaring away potential suppliers. A classic example is an organization that had a poor relationship with their transportation carriers, causing none of the major carriers to bid on their business. The benign approach can also lead to companies being taken advantage of. For example, a service provider developed a "gain-share" agreement with their client where the provider would receive a share of the savings if they found any. However, some clients came up with excuses as to why they did not have to pay.

Ultimately, the credible contracting approach is the best way forward. It involves creating a highly competitive supply chain and introducing credible commitments to mitigate risks. The approach challenges organizations to unlock inefficiencies and create fair and equitable hybrid contracts that benefit both parties in the agreement.

Advice to Practitioners: Organizations should avoid the muscular approach because it will result in a short-term win, but they will lose in the long term. Likewise taking a benign approach leaves the organization open to being taken advantage of. By far the best approach is a credible style like the Vested methodology where relational and collaborative agreements are backed up by clear and understandable measures along with a governance process that focusses on managing the relationship and the parties' behaviors.

Jean Tirole: The Science of Taming Powerful Firms

Jean Tirole is a French professor of economics at Toulouse 1 Capitole University. He is one of the most influential modern economists for his extensive theories and rigorous mathematic analysis of strategic behavior and information economics in what is known as "Industrial Organization" (IO). In 2014 he was awarded the Nobel Memorial Prize in Economic Sciences for his analysis of market power and regulation.

As part of his research, Tirole studied firms and markets where a firm had "power" to dominate the market and perhaps abuse that power. His research addresses two key questions: when a firm has market power, how will it behave; and how does its behavior affect the firm's suppliers, customers, and competitors?

Tirole's models are decidedly mathematical in nature, starting with individuals or firms that are assumed to be rational creatures out to maximize their utility and profits. He then usually incorporates the tools of game theory. While you might not find Tirole's deep thinking and mathematical analysis much fun to read if you are a business person – you likely will find his work worth consideration if you practice the art and science of structuring outsourcing agreements.

His findings? There are no standard answers for regulation and competition policy because solutions will vary among different, complex markets. Simply put, there is no one-size-fits-all approach to regulation and keeping a firm's power in check.

For example, the Nobel Committee on Economic Sciences said Tirole's work shows that cooperation on price-setting within a market is usually harmful, but cooperation regarding patent pools can benefit everyone involved. The merger of a firm and its supplier may lead to more rapid innovation, but it could also distort competition. Thus, a new way of looking at oligopoly markets was needed, because in the final analysis all regulation must be industry-specific.

Tirole, in his ***The Theory of Industrial Organization***[26] asserts the behavior of firms is "not a simple matter…there are many ways in which business decision makers may deviate from profit-maximizing behavior and many mechanisms that, in turn, limit managerial discretion." To put it bluntly – sometimes companies are tempted to justify less than ethical practices to maximize their profit. (Note – see Dan Ariely's book, The (Honest) Truth about Dishonesty: How We Lie to Everyone—Especially Ourselves, to learn more about how organizations and individuals justify their bad behavior.)

So how can you take Tirole's lessons and apply them in the real world of outsourcing?

First, business professionals need to look in the mirror and admit no business agreement is perfect. There simply cannot be a "standard template" for any complex outsourcing agreement. And if you try cram a complex business relationship into a standard agreement (or regulatory) framework you are likely to fail since by nature business people will tend to become opportunistic and try to "win" at the expense of their business partner (or when there is a lack of government regulation) if the door is left open.

Second, study the University of Tennessee's Vested Outsourcing business model. The Vested methodology starts with the fact that all complex contracts an incomplete – and that organizations need to create a "flexible framework" to manage the dynamic nature of business reality.

Advice to Practitioners: Vested's governance framework helps buyers and suppliers shift from a traditional "buy-sell" mentality to co-create an outsourcing agreement that is optimal for their specific relationship and business needs. The agreement is designed as a flexible framework, and parties jointly design mechanisms that help keep their interests aligned over time. If you craft a good agreement using the Vested model – your relationship will stay in balance just the way your home stays the right temperature.

[26] http://www.library.fa.ru/files/Tirole-Theory.pdf

Robert Solow: Innovation, Technology – and Math! – Make All the Difference

Robert Solow, the 1987 Nobel laureate in economic sciences, made the revolutionary (at the time) connection between innovation and economic growth. Solow showed over 50 years ago that technological improvements would be the major driver of economic growth. He defines technological improvements as "improvements in business processes or products." These technological improvements become the innovations that drive economic growth.

Common sense tells us that businesses grow when they innovate. And that those with the most amount of innovation benefit the most. But how does this relate to outsourcing? The primary point is that companies outsource processes in hopes that their service providers will drive advancements in the business functions they outsource. Solow likely could never have predicted the explosive growth in outsourcing as companies have used outsourcing to facilitate their own economic growth efforts in their search to cut the costs of non-core business processes or allow them access to new markets.

While Solow gained notoriety in 1987 with his Nobel Prize, his work stems from a lifelong effort to study and prove his concepts. Solow's growth model was first presented in an article entitled, A Contribution to the Theory of Economic Growth (1956)[27]. His starting point was that society saves a given constant proportion of its incomes. The population and the labor supply grow at a constant rate and capital intensity (or capital per employee) can be regulated. But without technological progress, Solow continued, growth rates for capital, labor and total production would all be about the same. As a result, technological development would be the motor for economic growth over the long haul. In Solow's model, if continuous technological progress can be assumed, growth in real incomes will be determined by technological progress.

His visionary model has had an enormous impact on economic analysis. His work laid the foundations for what was later to develop into what is known today as "growth accounting." But probably the most important contribution was that Solow demonstrated that only a small proportion of annual growth could be explained by increased inputs of labor and capital. Just how small? – 13 percent.

In other words, technological growth makes the crucial difference when it comes to economic growth – a whopping 87 percent. Now remember technological growth happens in two ways – product and process improvements.

So what is your focus when outsourcing? If it is purely labor arbitrage and searching for the lowest cost of labor or facilities in offshore countries you are probably missing the boat to tap into longer term and sustainable path to economic growth for your business. Remember that Solow's findings showed a full 87 percent of economic growth is driven from technological change in process and product improvements.

In his Nobel Prize Lecture, Solow said: "When I look back now at the articles I wrote in the 1950s and 1960s on this general subject, I am struck and even a little surprised at how much effort went into broadening the technological framework of growth theory."

In the lecture, Solow also quoted a warning issued by a leading student of the baseball statistics: "No amount of (apparent) statistical evidence will make a statement invulnerable to common sense."

Advice to Practitioners: Organizations outsource noncore processes in hopes that their service providers will drive technological advancements and increase value in the business functions outsourced. Unfortunately, far too many organizations outsource and focus on labor costs and labor savings. A better approach? Pick a supplier that is a true expert and create performance-based contracts with incentives that reward them for their technical advancements.

[27] http://piketty.pse.ens.fr/files/Solow1956.pdf

Joseph Schumpeter: "Creative Destruction"

Joseph Schumpeter, an Austrian Hungarian-American who died in 1950, was one of the twentieth century's great economic and political thinkers. Among other things, he was a professor of economics at the universities of Bonn, Tokyo, and Harvard. Schumpeter was also the finance minister of a socialist government in Austria and a staunch defender of capitalism, and he worried about the stagnation of capitalism and globalization long before there was even a term called globalization.

A central point of Schumpeter's work was that capitalism on the world stage can only be understood as an evolutionary process of continuous innovation and "creative destruction." This idea is becoming more mainstream with the work of Stiglitz (on making globalization work) and Haque (on the need to "disrupt" capitalism and make way for "constructive capitalists").

Schumpeter's most popular book in English is probably ***Capitalism, Socialism and Democracy***[28], published in 1942. The book opens with this famous quote: "Can capitalism survive? No. I don't think it can." While he was sympathetic to Marx's theory that capitalism would collapse, he veered sharply away from Marx, arguing that it might be destroyed by its success. He borrowed the phrase "creative destruction" from Marxist thought and made it famously his own by using it to describe a process in which the old ways of doing things are destroyed and replaced by new, better ways.

Capitalism he wrote, "is by nature a form or method of economic change and not only never is but never can be stationary." But the problem he saw was that the success of capitalism would lead to a form of corporatism featuring values hostile to entrepreneurial capitalism. Does this sound familiar? As I look at today's emerging version of capitalism and multinational corporation dominance of markets it seems very familiar. Schumpeter also worried that this process would hinder entrepreneurship.

But Capitalism, Socialism, and Democracy is more than a dire prognosis of capitalism's future. It is also a defense of capitalism on the grounds that capitalism sparks entrepreneurship. Schumpeter was among the first to lay out a clear concept of entrepreneurship by identifying the distinction between an inventor's inventions and an entrepreneur's innovations. He noted that entrepreneurs innovate not just by figuring out how to use inventions, but also by introducing new means of production, new products, and new forms of organization. These innovations, he argued, take just as much skill and daring as does the process of invention.

Innovation by the entrepreneur, he continued, leads to creative destruction as innovations cause old inventories, ideas, technologies, skills, and equipment to become obsolete. The question is not "how capitalism administers existing structures," he wrote, "... [but] how it creates and destroys them." This creative destruction, he believed, causes continuous progress and improves the standards of living for all.

He focused on innovation as the critical driver of economic change and progress. This seems obvious now but the debate about how best to foster an innovative climate of collaboration continues to the present day. Innovation and continuous improvement are buzzwords in the outsourcing industry but creating a framework for actually making them happen is why I think the Vested Outsourcing business model has arrived in the right place at the right time.

Schumpeter's influence on the theory of economic development was enormous. The theory's appeal lies in large measure in its simplicity and its power, characteristics evident when he wrote, "The carrying out of new combinations we call 'enterprise'; the individual whose function it is to carry them out we call 'entrepreneurs.'"

Advice to Practitioners: Schumpeter's ideas on creative destruction are needed now more than ever in outsourcing – collaboration, trust, innovation, continuous improvement and sharing value to get to win-win. Don't be afraid to slough off the old ways of contracting so as to adopt newer and more capable approaches.

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[28] https://www.amazon.com/Capitalism-Socialism-Democracy-Perennial-Thought/dp/0061561614

Steven D. Levitt: It's All about Incentives

Steve Levitt is the William B. Ogden Distinguished Service Professor of Economics at the University of Chicago, where he directs the Becker Center on Chicago Price Theory. In 2004, Levitt was awarded the John Bates Clark Medal, awarded to the most influential economist under the age of 40. In 2006, he was named one of Time magazine's "100 People Who Shape Our World."

You have likely heard of the wonderful work of by the academic economist Steven D. Levitt on ***Freakonomics***[29] and ***Superfreakonomics***[30]. Levitt teamed with his journalist collaborator Stephen J. Dubner to create two bestsellers. The books are fun and clever, but more importantly they reveal basic insights about human economic activity while exploring "the hidden side of everything."

The books are based on some fundamental concepts:

- "Morality is what people should do. Economics is what people do."
- "The conventional wisdom is often wrong"
- "Incentives are the cornerstone of modern life"
- "Dramatic effects often have distant, even subtle, causes"
- "Knowing what to measure and how to measure it makes a complicated world much less so"

One of Levitt's most powerful points is what he calls the "law of unintended consequences." While he tells lively stories of how unintended consequences drive the behaviors of schoolteachers, realtors, crack dealers, prostitutes and expectant mothers, this law also greatly affects outsourcing deals as well.

In fact, an outsourcing deal that is not collaboratively planned, tracked and governed will suffer from all sorts of random, unintended but predictable negative consequences.

Levitt stresses in his second book, ***Superfreakonomics*** that "People respond to incentives." Incentives are the "cornerstone of modern life," and while people respond to them, unfortunately they do not necessarily respond "in ways that are predictable or manifest," which is where unintended consequences enter the fray and become perverse incentives. Our research has also found that some of the most successful outsourcing deals leverage incentives heavily to motivate service providers. Deals are structured around business results – or Desired Outcomes – versus paying a service provider by transaction or headcount.

Companies should always incorporate incentives – whether they are cost, performance, awards or nonmonetary incentives – that are mutually beneficial to the parties in order to offset the flaws of using conventional firm fixed price or cost-reimbursement models, which can lead to perverse incentives. If one side's incentives come at the expense of the other side, then the outsourcing deal is in jeopardy. The challenge is to motivate outsourcing teams to make collaborative decisions on pricing, performance and outcomes that ultimately will translate into the incentives that breed success and the win-win.

In outsourcing, it's important to consider Levitt's insight: "Morality is what people should do. Economics is what people do." He also says that "in economics as in life, you'll never find the answer to a question unless you're willing to ask it, as silly as it may seem."

Advice to Practitioners: If you are looking to structure an outsourcing deal, you'll never find the right incentive package unless you're willing to ask the right questions with your outsourcing partner. So rather than use your procurement and negotiation muscle, stop and ask the service provider what motivates it and how it would structure a deal that's designed to achieve what you want. It is also important to understand what it is that you want more of from your supplier and then incentivize them to give it to you..

[29] https://www.amazon.com/Freakonomics-Economist-Explores-Hidden-Everything/dp/0060731338
[30] https://www.amazon.com/Super-Freakonomics-Patriotic-Prostitutes-Insurance/dp/0060889578/ref=tmm_hrd_swatch_0?_encoding=UTF8&qid=1674062932&sr=1-1

Horacio Falcao: The Value of Value Negotiation

Horacio Falcão is a Professor of Management Practice at the Decision Sciences Dept. at INSEAD, where he teaches and researches on Negotiation Sciences. He is the creator of the Value Negotiation system: a strategic and flexible approach to negotiation designed to maximize rewards at minimum risk in an international and complex world.

Falcão warns companies should not start – nor necessarily end – on "price" when it comes to negotiations. Falcão has written on the concept of value for several years and his work includes the 2010 book ***Value Negotiation: How to Finally Get the Win-Win Right***[31].

What does Falcão mean by "value negotiation"? In his book he says that value negotiation "aims to be the negotiation system that focuses on delivering the most possible value at the least possible risk in the widest range of situations." He called value negotiation a "new branch" of win-win negotiation—specifically citing the "Principled Negotiation" approach introduced in the bestseller Getting to Yes, by Fisher, Ury and Patton.

The idea of delivering the "most possible value at the least possible risk" might sound good but it strikes me as also somewhat one-dimensional. There's much more to delivering value than simply avoiding or shifting risk. In a collaborative Vested Agreement, for example, one or both parties might agree to take on more risk—in terms of investments, say—for the overall good of the relationship and to spur innovation.

Falcão has refined his thinking with his latest writings (with negotiation consultant Filip Hron) in the INSEAD Knowledge blog. They contend that "negotiations should never come down to price," and that "focusing a negotiation on price puts both sides at risk of leaving out other interests that are more important."

Value is difficult to define objectively, especially when two or more vendors offer the same commodity or service. So does the negotiation then come down to "price?" Falcão and Hron say "no!" on two counts: Two vendors offering seemingly non-differentiated products such as electricity, drinking water or coal will differ in their ability to address a company's specific interest. "One will have better reliability. One will have more responsive service. One will have more competent support staff. One will have more flexible billing. And so on."

Falcão and Hron highlight that negotiations should be thought of as a system. They state, "You cannot change one element of the system without sending ripple effects of reactions and consequences through that system. The likelihood and magnitude of these consequences, when they occur, and whom they affect, will vary."

Finally, they warn negotiators should remember that "changing the price changes something else in the negotiation. That's because price is merely one out of ten, twenty, or even a hundred interests present in the transaction." Falcão and Hron add that "price is often dealt with last, but not because 'negotiations come down to price'. Rather, from our observations, it appears that most people actually fear the price negotiation."

That's because negotiators often do not have a clear understanding of their own and another party's interests. So, the default position becomes a myopic focus on price. It is difficult, if not impossible to achieve a win-win relationship in that context.

Advice to Practitioners: Focus on Falcão's emphasis on not using power He notes a win-win approach "happens when at least one party tries to get what he or she wants with the other party's consent and without the need to use or display power." Use the Vested Getting to We process to lay a strong foundation for a business relationship – including developing negotiating rules that help the parties to negotiate on the same page, so to speak, on deal specifics, including price.

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[31] https://www.amazon.com/Value-Negotiation-Finally-Win-win-Right/dp/9810681437/ref=tmm_pap_swatch_0?_encoding=UTF8&qid=1674063502&sr=1-1

Deirdre McCloskey: Are Markets Moral?

Deirdre Nansen McCloskey is Distinguished Professor Emerita of Economics and of History, and Professor Emerita of English and of Communication, adjunct in classics and philosophy, at the University of Illinois at Chicago. She also spent five years as a visiting Professor of philosophy at Erasmus University, Rotterdam. McCloskey trained at Harvard in the 1960s as an economist, and has written twenty-four books and some four hundred academic and popular articles on economic history, rhetoric, philosophy, statistical theory, economic theory, feminism, queer studies, liberalism, ethics, and law.

Economist and philosopher Deirdre McCloskey has some thought-provoking and highly nuanced takes on innovation and ethics in the commercial arena. Over her long career she has done some deep thinking on the intersection of economics, markets and morality.

How about this for starters: capitalism is innovation, in her estimation. And she contends that capitalism/innovation backed by liberal economic ideas “has made billions of poor people pretty well off, without hurting other people.” Did I mention she is also controversial?

McCloskey laid out the essence of her thinking in three of her books that come under the overall theme she calls the Bourgeois Era: ***The Bourgeois Virtues: Ethics for an Age of Commerce*** (2006); ***Bourgeois Dignity: Why Economics Can’t Explain the Modern World*** (2010); and the upcoming ***The Treasured Bourgeoisie***.

The motivation of the trilogy, she says, is to persuade what she calls the “clerisy”—the intelligentsia, communicators, shapers of minds, etc.—that “capitalism can be ethical; it can be unethical, and that is a choice we face—it’s not built into the nature of the system.” McCloskey’s central point is that individuals and organizations “can live an ethical life in a commercial society.”

The modern way to do that, she continues, is to balance life in commerce with the virtues of love, courage, temperance, justice, faith, hope and prudence. Did I mention she’s a maverick in a multitude of ways?

Where most of today’s economists fall short lies in their “conception that economics is only about prudence…prudence only is not sufficient for a truly scientific economics.” She argues for “humanomics” instead. Because the economy “depends massively on cooperation, economists need to stop telling people that all that matters is prudence.” The other virtues need to be included.

McCloskey also insists that unlike what most economists preach, capital accumulation is not what made the modern world - “this is rubbish!” It’s ideas that matter and “how we think of each other…it’s about sociology, not psychology.”

She argues that the important flaw in economics “is not its mathematical and necessarily mistaken theory of future business cycles, but its materialist and unnecessarily mistaken theory of past growth.” The ‘Big Economic Story’ of present times is not the Great Recession of 2007-2009, it is that the “Chinese in 1978 and then the Indians in 1991 adopted liberal ideas in the economy, and came to attribute a dignity and a liberty to the bourgeoisie formerly denied. And then China and India exploded in economic growth.”

McCloskey’s moral is that in achieving a pretty good life for the mass of humankind, and a chance at a fully human existence, “ideas have mattered more than the usual material causes.” Simply put: we become rich by “gigantically increasing the size of the pie.”

Advice to Practitioners: Whether you agree with all she says or not, McCloskey makes a definite point that we need to “abandon the materialist premise that reshuffling and efficiency, or an exploitation of the poor, made the modern world.” Rather a new science of history and the economy is needed, “a humanistic one that acknowledges number and word, interest and rhetoric, behavior and meaning.”

Joseph E. Stiglitz: Making Globalization Work

Joseph E. Stiglitz is an American New Keynesian economist, a public policy analyst, and a full professor at Columbia University. He received the 2001 Nobel Prize (with George A. Akerlof and A. Michael Spence) for his analysis into how markets work with asymmetrical information. He is a former senior vice president and chief economist of the World Bank, Chief Economist of The Roosevelt Institute, and co-founder and President of the Initiative for Policy Dialogue (IPD).

Since winning the Nobel Prize, Stiglitz has written and lectured extensively about globalization and markets with this unsettling message: they aren't working very well, especially in the context of the new realities of the twenty-first century. Stiglitz began making his claims that we need to rethink how we approach globalization even before the 2008 global economic and financial meltdown. In fact, he has two books on globalization, ***Globalization and Its Discontents*** (2002) and ***Making Globalization Work*** (2006). His most recent book, ***Freefall*** (2010), recounts the events of the 2008 economic collapse and how its effects still persist.

In a 2006 lecture on globalization[32], Stiglitz said, "Something is wrong with the way globalization is turning out. It has not lived up to its promises, and the question is what to do about it."

Stiglitz points out a critical flaw. "The global financial system is not working the way it ought to. Ordinary laws of physics say that water ought to flow downhill. The parallel in economics is that money is supposed to flow from rich countries to poor countries, and risk is supposed to be transferred from the poor, who are least able to bear it, to the rich. But in the world today, things are moving in the opposite direction. To be precise, for the last several years, money has been going from the poor countries to the rich – the net flow of funds is going in the opposite direction of the way it should."

He continues: "Meanwhile, the poorest countries in the world are left to bear the risks of interest rate and exchange rate volatility. The result of this has been that, in spite of the fact that economists know a lot more about how to manage an economy today than they did fifty years ago, there have been more than a hundred crises in the last three decades."

There is much food for thought for outsource practitioners in Stiglitz's words –especially as it relates to supply chain sustainability. It's no surprise that globalization has meant that we have become more integrated and more interdependent. While globalization brings much value, it also poses challenges in how we need to think (or rethink) existing approaches to globalization around intellectual property, trade, global financial markets, natural resources and the environment.

In his book ***Freefall***, Stiglitz points out The Great Recession and its aftermath "is forcing us to rethink cherished views." He asserts "The issue is not whether globalization is going to change; globalization will change. The current system simply cannot continue."

Stiglitz advocates for more collaboration and win-win approaches. "Greater inter-dependence means that we have to act together; we have, as economists would say, extra responsibilities which mean that we have more need to act cooperatively."

Advice to Practitioners: If there is any lesson outsource practitioners can take from the global economic collapse of 2008, it is that market decisions based on greed, total self-interest, a knee-jerk aversion to even basic regulation, the constant drive to shift risk and blame while relying on the market to correct itself is not a sustainable model. Building relational agreements that are not only fair but also contain built-in flexibility to deal with the challenges that changes in the global economy will throw up.

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[32] https://econpapers.repec.org/article/esojournl/v_3a39_3ay_3a2008_3ai_3a3_3ap_3a171-190.htm

PART THREE:

Learnings from Lawyers and Legal Scholars

While many lawyers focus their contracting efforts on writing the perfect ‘legal weapon’ – a term used by legal scholar Ian MacNeil – there are pioneers who are helping organizations learn the benefit of a more nuanced understanding of contract law—one that emphasizes the importance of collaboration, mutual respect, and ethical considerations in contractual relationships.

We begin our exploration with the pioneering work of Stewart Macaulay and Ian Macneil who laid the foundation for our work at the University of Tennessee on relational contracting and the Vested business model. Macaulay – the most cited legal scholar of all times - is challenged traditional views of contract law and introduced the world to the concept of relational contracts. Building on this foundation, Ian R. Macneil introduced the concept of cooperative contracting, which emphasizes the dynamic nature of contractual relationships and the importance of ongoing cooperation and adaptation.

We also explore diverse topics so such strategies for dealing with incomplete contracts, how to make contracts easier to understand using tools such as visualization and plain language, and why organizations should challenge using standard contract templates.

Stewart Macaulay: Pioneer for Relational Contracting

Stewart Macaulay—Professor of Law Emeritus, University of Wisconsin Law School—occupies a unique place in the evolution, awareness and acceptance of relational contracting. In fact, one might safely argue that he helped set relational contract theory in motion in 1957, with the publication of his famous article, "Non-Contractual Relations in Business: A Preliminary Study." He was 26.

Over Macaulay's long career he has written engagingly and intriguingly about contracts, and even "freedom from contracts." At one point he was dubbed the "the Lord High Executioner of the Contract is Dead Movement." He declined that honor but did concede that the so called "academic contract" was dead while the real institution was alive and well. He likes to use dialogue from Dilbert cartoons to illustrate his points.

Macaulay's research turned the premise of a contract on its head; businesses wanted contracts, but business people often did not. Often, business people simply ignored their contracts because contracts came with undesirable consequences. Macaulay rightly stated that detailed "negotiated contracts can get in the way of creating good exchange relationships between business units." An insistence on a very detailed contract "indicates a lack of trust and blunts the demands of friendship, turning a cooperative venture into an antagonistic horse trade. … Businessmen may welcome a measure of vagueness in the obligations they assume so that they may negotiate matters in light of the actual circumstances."

"The phrase 'freedom of contract' carries philosophical, ideological, and symbolic baggage," he wrote in "Freedom from Contract: Solutions in Search of Problem?"[33] Macaulay noted, "Many, and probably most, parties to contract disputes do not litigate or even threaten to do so. Some know that if they went to court, they would lose. However, many who might or almost certainly would win do not litigate."

It is easy to overstate the importance of contract law; this is because "relational sanctions and private governments do most of the work of protecting expectations and reliance." For that reason, contract law in practice is "a flawed product that costs too much in most situations."

Macaulay has also inspired many others, including fellow big thinker and relational contracting guru Ian Macneil, and our work at the University of Tennessee on Vested. Macneil pointed to Macaulay's 1957 article as a "demolition effort" that cleared the way for relational contract theory. For his part, Macaulay asserts he is a "card-carrying member of the Macneil party," and that he knew and has admired Macneil for more than 40 years.

One of the most powerful lessons in both Macaulay's and Macneil's work is that contracts should be viewed as "organic" agreements—a living, collaborative document that exists as a legal and social entity, one that evolves as the nature of the relationship changes. In his paper, "Relational Contracts Floating on a Sea of Custom?" Macaulay says contract law plays the symbolic role of "reinforcing the sense of organic solidarity."

While Macaulay's research provides empirical evidence on why contracts were not used to the extent expected and why contracts were used at all, these answers are not what has made him the most cited academic scholar. Rather, Macaulay's legacy stems from the intriguing questions he posed that have been engaging contract scientists of all disciplines ever since. From a certain perspective, the different branches and dimensions of the science of contracts for the past 50 years can be said to be different attempts to answer these questions and other questions closely related to them.

Advice to Practitioners: Macaulay emphasizes that relationships are not fixed once and for all time, and because people may rely on the need for changes, strict reliance on the original paper deal may be unfair. He writes, "It is one thing to make temporary concessions to keep a relationship alive. It is another to redefine what is expected under the contract. Much turns on what one party communicates to the other and on the reasonableness of a significant change of position."

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[33] https://uwlaw-omeka.s3.us-east-2.amazonaws.com/original/3ca94b2d203821b0ee607c8b50e18aaaf510c640.pdf

Ian R. Macneil: Cooperative Contracting

Ian Macneil (1929-2010) joined the law faculty of Cornell University in 1959. In 1980, he became the John Henry Wigmore Professor of Law at the Northwestern University School of Law, a position he kept until becoming professor emeritus in 1999.

Ian R. Macneil turned conventional views about contracts upside down more than 40 years ago with his ideas about business cooperation. Back in 1968, Macneil observed that most contracts are ill-equipped to address the complexity of business needs in his seminal work Contracts: Instruments for Social Cooperation[34]. He wrote, “Classical law views cooperation as being ‘of little interest’ and external to the agreement. This argues for an agreement framework that encourages cooperation and dialogue.”

Macneil’s work revealed that “somewhere along the line of increasing duration and complexity (the agreement) escapes the traditional legal model.” He argued that contracts are tied to the classical contract law approach, crafted to address transactions and provide legal protections such as pricing and price changes, service levels, limitation of liability, indemnification and liquidated damages.

His breakthrough message was that business agreements can be effective and governed efficiently “only if the parties adopt a consciously cooperative attitude.” His idea was that contracts are rooted in relationships and activities that have a large context, rather than as the discrete transactions we usually see written into a contract. Macneil’s work was instrumental in developing a wider view of the contract that today is called “relational contract theory.”

Unlike the discrete contract, which is characterized by a short-duration of exchange, a relational contract typically covers a longer duration. The objects of exchange may include easily measured quantities, such as hours worked but also objects not so easily measured or quantifiable, such as customer satisfaction, engagement, innovation, or flexibility.

In his article “Values in Contract, Internal and External”, Macneil said, "Man is both an entirely selfish creature and an entirely social creature, in that a man puts the interests of his fellows ahead of his own interests at the same time that he puts his interests first. … Man is, in the most fundamental sense of the word, irrational, and no amount of reasoning, no matter how sophisticated, will produce a complete and consistent account of human behavior, customs or institutions."

Unfortunately, Macneil was ahead of his time and far too many business people (and lawyers!) have ignored his advice. Tim Cummins, chief executive of the International Association of Contract & Commercial Management, explains: “Too many contracting and legal professionals either fail or feel unable to alter their negotiation priorities to reflect the potential value or the extent to which its realization depends on cooperation.” The result is that contracts become exercises in me-first, power-play games, seen as obstacles to value creation rather than as fundamental assets to successful collaborative relationships. This is as true today as when Macneil first made his observations.

But even more frustrating: the contracts community – or at least 80 per cent of those that responded to a recent IACCM survey – recognizes that practices focusing on strict legal and transaction-based contract provisions do not result in the best outcome.

Advice to Practitioners: Perhaps the old sayings of "what goes around comes around" and "what’s old becomes new" are true. It has been a long time since Macneil issued his challenge for collaboration in the contracting world. As another famous man said back in the 1960s: “If not now, when?” The good news is that Macneil’s stellar advice is starting to gain traction in the business world. The rise of Vested and its approach to collaborative, outcome-based partnerships is firmly based on the concepts articulated by Macneil decades ago. What took 50 years?

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[34] https://lawcat.berkeley.edu/record/471809?ln=en

Ronald Dworkin: Trust and Treating Each Other as Equals

Ronald Dworkin was an American philosopher, jurist, and scholar of United States constitutional law. At the time of his death in 2013, he was Frank Henry Sommer Professor of Law and Philosophy at New York University and Professor of Jurisprudence at University College London. Dworkin had taught previously at Yale Law School and the University of Oxford, where he was Professor of Jurisprudence.

To keep a society intact, citizens must accept the existing law and order. A stable society requires that the members of that society perceive the existing order as justified. Legitimacy is of crucial importance for long-term business relationships as well. These relationships require, for their stability through changing circumstances and interests, a feeling that the partners' rights and obligations are justified, legitimate.

Ronald Dworkin, one of the most influential legal and political philosophers in modern times, has convincingly argued that the necessary legitimacy will be present only in communities or associations with certain characteristics. One characteristic is the presence of fundamental and guiding principles. The path of collaboration can be found, and a continuous alignment of interests can only be achieved if the parties always have a feeling that the obligations that the partnership imposes are justified, meaning they are based on a set of principles or social norms that apply equally to all partners.

Dworkin argued that a distinction can be made between what he called "bare" communities and "true" communities. This distinction is similar to the distinction between arms-length and embedded ties discussed by Uzzi. Dworkin also calls the true community a community of principles.

A business contract can be said to constitute a community between the parties to the contract. This community will be a "bare" community in Dworkin's sense if the parties follow the rules of the negotiated agreement and have no sense of obligation towards each other beyond that. The negotiated rules of a bare community represent a compromise between antagonistic interests. The dominating negotiation methods today will only lead the parties to such a bare community.

A business relationship will instead be a "true" community when the parties view the written rules of the contract not as exhaustive of their obligations but instead as being expressions of a set of common principles, or social norms, that they all agree upon and that apply equally to everyone. The parties must treat each other's interests and needs with equal concern.

Dworkin views this latter kind of business relationship as a fraternal association and says, "A commercial partnership or joint enterprise, conceived as a fraternal association, is in a way different from even a long-standing contractual relationship. The former has a life of its own: 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."

Dworkin wrote not as a sociologist or economist describing facts of the world but as a legal philosopher arguing how political society should be organized to be justified. There is no doubt, however, that the California cattle ranchers lived in a community of principles in Dworkin's sense. They developed a set of norms that governed their day-to-day interactions in a manner that led to a welfare-maximizing outcome for everyone.

Using economic and sociological terminology, relations between organizations need to be embedded. Embedded relationships foster a mutually advantageous collaboration based on a continuous alignment of interests. A web of social norms or guiding principles that continuously justify mutual rights and obligations and guide people's actions as rights and obligations change over time.

Advice to Practitioners: In embedded relations, the parties are guided not only by their economic interests but also by social norms or principles such as reciprocity and loyalty. Negotiators wanting to harvest the benefits of collaboration should aim for a community of principles, based on which mutual rights and obligations they can iron out.

David Campbell and Donald Harris: Cooperation's Role in Long-term Contracting

David Campbell is a British professor of law who specializes in English contract law. He is currently at Lancaster University. He joined Lancaster in 2013 from Leeds University. Before Leeds he was professor at Durham University where he was for a time Head of the Law Department. Prior to his passing in 2020, Donald Harris was Director of the Centre for Socio-Legal Studies at Oxford University, an institution which he helped create, and which he directed for the first twenty-one years of its life.

Academics and big thinkers have buttressed the importance of trust and collaboration in outsource deals. While it may seem like an anomaly, or at least a new idea, to mention cooperation and contracts in the same breath, it's neither. In fact, cooperation is vital to the long-term success of contracts, as David Campbell and Donald Harris pointed out in 1993 in the Journal of Law and Society.[35]

The article says there is a "fundamental shortcoming" in the way classical law addresses long-term contractual behavior. "Efficient long-term contractual behavior must be understood as consciously co-operative," they wrote. "We see a long-term contract as an analogy to a partnership. The parties are not aiming at utility-maximization directly through the performance of specified obligations; rather, they are aiming at utility-maximization indirectly through long-term co-operative behavior manifested in trust and not in reliance on obligations specified in advance."

Campbell and Harris draw a distinction between the "cooperative mechanism" of the effective, useful long-term relationship and that of a short-term, highly specific contract. Flexibility and open-mindedness are the key. "The precise conduct required by future long-term co-operation is necessarily unable to be specified in advance and the shares in the joint product of that co-operation are equally often not specified in advance," they write. "The parties accept a general and productively vague norm of fairness in the conduct of their relationship."

The authors are spot-on when they say, "as bluntly as clarity requires, that the explanation of long-term contracts requires the rejection of immediate individual self-interest as the measure of economic rationality and its replacement by common interest as this measure."

They continue that the "adequate form of self-interest in long-term contracts is co-operation." They further assert an emphasis on individual self-interest in the long-term contract "as a rationally discussable theoretical concept is now so unproductive that it must be rejected in the explanation of long-term contracting and in this there is entailed a very strong criticism of the heart of the classical law."

That may be a politely academic way of saying they want to blow away the "heart" of classical law – especially when dealing with strict risk liabilities and extra-legal strategies when liability occurs – as applied to long-term contracting. The degree of flexibility that results through long-term cooperation "seems to make the classical law more or less irrelevant to these contracts."

The authors' model draws heavily on the transaction cost economic analyses and flexible framework insights of Oliver Williamson and Ronald Coase and in the ideas on contracts as instruments of social cooperation expressed by Robert Macneil.

Advice to Practitioners: Their detailed treatise is a worthwhile addition to our understanding of contracts that further buttresses the Vested principle of replacing self-interest with common interest and collaboration as the basic measures of "economic rationality" in contracting. By adopting this approach practitioners will find that 'win-win' agreements are not impossible to achieve.

[35] Campbell, D and Harris, D "Flexibility in Long Term Contractual Relationship" (1993) Journal of Law and Society, p 166

Avery W. Katz: Dealing with the Incomplete Contract

Avery W. Katz is the Milton Handler Professor of Law and Reuben Mark Professor of Organizational Character at Columbia Law School. He is a widely respected authority on contract law and has produced scholarship on topics ranging from option contracts to contractual incompleteness, contract theory, and fee shifting. He served as chair of the section on law and economics at the American Association of Law Schools (2001), Scholar in Residence at the New York University School of Law (2004), editor of the International Review of Law and Economics (2003 to 2013), and member of the board of directors of the American Law and Economics Association (2003 to 2006). Katz currently sits on the advisory board for Contracts and Commercial Law Abstracts.

Avery W. Katz, professor of law at Columbia Law School, tackles the conundrum of "incomplete contracts. The challenge? How can organizations fashion a contract that is both economically flexible enough for a business relationship to move forward efficiently and legally secure enough to satisfy the parties' legal departments?

We have written about incomplete contracts before – frequently highlighting the great work of Nobel laureate Oliver Williamson, who advised that organizations shift to "credible" contracts governed under a "flexible framework".

While both men promote flexibility in a contract, as a legal scholar Katz brings a different – but very complementary angle to Williamson's work. Katz's article, "Contractual Incompleteness: A Transactional Perspective[36]," approaches the subject from a broader public-private legal outlook than Williamson does. He talks about the business contract as a sort of "private lawmaking" between the parties engaged in economic activity, as opposed to the more policy-oriented approach, or "public lawmaking", of contracting written with legal protections (i.e., public officials, courts) in mind.

Katz advocates that legal scholars focus more on addressing the contractual decisions of "private lawmakers (that is, transactional lawyers and their clients) and less on the decisions of public lawmakers (that is, courts and legislatures)". Stated in another way (in Katz's academic language of law and economics), "scholars should pay greater attention to considerations of private transactional efficiency as opposed to larger issues of social efficiency."

Simply put, don't wait for the courts to weigh in on a contract difficulty or dispute. The primary lesson from the literature on incomplete contracts stresses that courts are not in a position to effectively supervise many of the things that the parties know and do in negotiating and performing their agreement, Katz says. That's because the contracting parties at the table have more information—and they have it early on in the negotiating process—than courts do later on. He adds that from an economic viewpoint, maximizing contractual value requires a proper balance, incentives and tradeoffs to achieve efficiencies. The parties are in a better position to negotiate those items—and thus avoid legal disputes—before the contract is locked in place.

Katz's work clearly confirms the need for a methodology to address incomplete contracts. The University of Tennessee's development of the Vested methodology points to the how of crafting a complex business agreement, which by nature will be incomplete.

Advice to Practitioners: Understanding the nuances of how to best "architect" a strategic business deal is one reason the University of Tennessee created the "Certified Deal Architect" program, which is aimed at teaching the art and science of crafting an agreement in a highly dynamic environment where certain things (the impact of innovation and collaboration, for example) are unknown.

[36] https://scholarlycommons.law.case.edu/cgi/viewcontent.cgi?article=1633&context=caselrev

Haapio and Barton: Business-Friendly Contracting

Helena Haapio is a Contract Strategist at Lexpert Ltd., an Associate Professor of Business Law at the University of Vaasa, and a Professor of Practice and a Docent of Proactive Law and Contract Design at the University of Lapland. Thomas D. Barton is Professor of Law Emeritus at California Western School of Law. In addition to teaching contracts law and problem-solving topics, his interests reflect his expansive knowledge of the social, historical, and intellectual contexts of law.

Haapio and Barton are on a mission to educate organizations on how to create "business friendly" contracts – without giving up safety or security. A chapter in the recently published ***Liquid Legal: Transforming Legal into a Business Savvy, Information Enabled and Performance Driven Industry***[37] highlights the need for contracts to be used as business tools rather than legal tools, and as business enablers rather than as obstacles. They argue that contracts must ensure that an agreement can be legally enforced, but contracts should also be written using language that is comprehensible to everyone involved in forming and implementing the exchange.

They write: "By changing the design of contracts and the ways in which those contracts are communicated—through simplification and visualization, for example—legal and business operations can be better integrated. Contracts can then be more useful to business, and contract provisions can actually become more secure by becoming easier to negotiate and implement."

The building blocks of business-friendly contracts are simplicity, visualization and collaboration. In short, keep the contract language as simple and clear as possible, enhance understanding by employing visual images to supplement the text, and collaborate so that the parties are working as partners. Some points to consider in fashioning business friendly contracts, according to Haapio and Barton:

- Lawyers and business managers should "realize the destructive impacts of jargon-laden, self-protective contract language. Such language can: (1) impair implementation of the contract; and (2) lead eventually to missed value and opportunities in the economic exchange itself."
- The way in which concern for security is addressed ends up "undermining opportunity." The opposition between security and opportunity is not inherent or necessary.
- When lawyers' draft contracts, they often focus too strongly on imagined courtroom settings, rather than the far more immediate business settings.
- Lengthy negotiations and missed opportunities "often stem from the difficult language that is routinely used in contracts. The language can needlessly isolate lawyers and business negotiators from one another, because business negotiators cannot readily participate fully in creating the legal agreements that should be memorializing the discussions among contracting parties."

Haapio and Barton state contract security is enhanced through greater understanding, clarity of purpose, flexibility and trust, and advocate for incorporating more proactive and preventive law (PPL) methods into the contracting process to eliminate the dysfunctional cycles that generate recurring losses. They write:

Preventive Law focuses on dysfunctional cycles that generate recurring losses. It seeks to identify and understand the conflicting elements of a system, that unless somehow resolved, will continue to generate problems. Proactive Law adds a focus to achieving positive goals and value. Together, PPL can alter mentalities and harness tools toward smoother operations and successful outcomes.

Advice to Practitioners: Incorporating PPL methods add much needed relational aspects to the contracting process. Haapio and Barton write, "A relational focus will expect occasional disruptions in contractual implementation. This focus will also accept the need to be flexible and accommodating, based on a reservoir of trust and long-term mutual benefit."

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[37] https://www.amazon.com/Liquid-Legal-Transforming-Information-Professionals/dp/3319458671

Russell Korobkin: Why Standard Contract Terms Can be Bad for You?

Russell Korobkin is the Vice Dean for Academic and Institutional Affairs and the Richard C. Maxwell Professor of Law at UCLA School of Law. He is the author of three books and over 50 law journal articles in the fields of behavioral law and economics.

If your company is like most, it promotes “boilerplate” contracts or at a minimum, pushes for standardized terms, such as the contract length, warranties, a 30-day termination of convenience clause or 90-day payment terms. While this may make your lawyer and CFO happy, Russell Korobkin suggests using standard contract clauses is a bad idea.

In his 2003 research paper, “Bounded Rationality, Standard Form Contracts, and Unconscionability”[38] his premise is that contracts will often include terms that are “socially inefficient” and thus are not rational. And when these terms make it into a contract it can leave buyers worse off than they would be if their contracts included only efficient terms.

Korobkin believes “no party should have the ability to force another party to accept specific terms.” But when you look at the way it works in the real world, through the lens of behavioral economics, conventional wisdom does not hold up. Why? People make decisions that often do not align with classical economic models. This is especially true where one party may hold market power and thus can dominate the contract negotiation. In the real world – buying organizations (especially large buying organizations with lots of market power) – use their market power to include standard contract terms that favor themselves even when those terms are not efficient for a specific deal.

Let me take Korobkin’s research and show how a standard contract term can easily cause a perverse incentive. A termination for convenience clause (which is widely used contracts today) gives a party total freedom to end the contract after the specified period. While it’s great to reduce risk, it is an innovation killer. Why? A CFO at a supplier explains. “A 60-day termination of convenience translates to a 60-day contract. It would be against our fiduciary responsibility to our shareholders to invest in more than two months of profit in a client with a 60-day termination clause. And when you do the math on a $100,000-a-month contract with a 5% profit margin, it means we never invest on anything with more than a two-month return on investment, buyers are crazy to expect us to invest in innovations if they do the math.”

So why doesn’t the supplier push back and educate the buyer on that perverse incentive? The sales person for the company says, “We try, every time we suggest redlining the contract we are told ‘you are hard to do business with’ and ‘we have benchmarked you against your competitors who don’t have an issue with it.’”

Starting with form contracts also created what is known as the status quo bias. Behavioral economics proves that once someone has something, they will always favor the status quo – even if it is not as good and a better option. So in contracting – the simple act of introducing a standard contract form anchors a buyer into not changing, even if it is good for them.

Korobkin found that “current judicial doctrine is not well calibrated to the goal of mitigating the pernicious effects of form contracts.” He recommended that courts should modify the unconscionability doctrine to better police inefficient form terms.

Advice to Practitioners: Make standard form contracts much less formal, especially in complex relationships. Think about each of the clauses and the purpose of the clause. And ask suppliers to begin to explain why a clause is bad and hurts them. You are likely to learn you’ve accidently baked in many perverse incentives. This especially a factor in large, complex services contracts where the supplier has customized its work for the buyer; the potential for process improvements and investments in better ways of working can yield significant benefits.

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[38] https://chicagounbound.uchicago.edu/uclrev/vol70/iss4/2/

Julian Nyarko: Stickiness and Incomplete Contracts

Julian Nyarko is an Associate Professor of Law at Stanford Law School, where he uses a combination of quantitative methods, natural language processing and machine learning to explore the realities of contract design under U.S. and international law. Nyarko studied law at the University of Hamburg Law School and received both an LL.M. and a Ph.D. from the University of California, Berkeley. In addition, he was a Fellow in Empirical Law and Economics at Columbia Law School.

Nyarko has researched an interesting concept he calls contract "stickiness." His findings? Once a contract's terms or covenants is written into a contract it "only rarely" gets changed or improved – hence the concept that contract terms are sticky.

Nyarko's research analyzing covenants in corporate and government bond agreements led to his 2019 paper, "Stickiness and Incomplete Contracts[39]." Nyarko argues that economic and legal theory assumes that "sophisticated" parties will routinely write agreements that optimize their joint expertise, or "surplus." But Nyarko's research found that theoretical good practice does not make it into real practice. Rather, people tend to use the same clauses over and over again – even if they don't make sense.

The stickiness comes from over-reliance on templates and whether a contract includes a forum selection clause driven by the template used in the first draft. Nyarko found there is a "distinct apathy" among transactional lawyers that perpetuates contractual gaps, and that "sticky" drafting practices characterize the most fundamental aspects of commercial transactions across a wide range of contexts. Simply put, organizations get lazy when they use contract templates.

Nyarko tested the stickiness hypothesis in several steps. He examined whether the law firm is a relevant actor in the decision whether to include a "choice-of-forum provision" or not. He investigated that question by considering the degree to which these clauses vary with external counsel, holding the parties to the agreement (and other observable characteristics) constant.

After establishing that the hiring decision of external counsel significantly influences whether or not parties have a choice-of-forum clause in their agreement, he studied the influence of the law firms' template on the presence of choice-of-forum provisions. He did this by identifying the law firm that proposed the first agreement draft, as well as the template the draft is based on. He then considered whether or not law firms bargain over the presence or absence of forum selection clauses as found in the template.

Finally, Nyarko considered whether law firms can be induced to make changes to their drafting practice with respect to choice of forum provisions in response to external shocks that change the costs and benefits of including the clause.

Nyarko's research supports what behavioral economist call the "status quo bias," which means that people prefer things to stay the same by doing nothing or by sticking with a decision made previously. However, Nyarko's article is significant because it is the first to provide comprehensive evidence for the stickiness hypothesis across multiple types of commercial agreements. It is also the first to demonstrate that even contractual gaps, rather than written clauses, can also be sticky.

Advice to Practitioners: "The stickiness of contractual gaps is the result of a heavy reliance on templates by external counsel during the drafting process, suggesting that default rules are more important than is traditionally assumed. A better understanding of how law firms form their preferences and how these preferences diverge from their clients' can greatly increase the predictions generated from theories of contracting and guarantee that they remain practically relevant." Nyarko's article illustrates the danger inherent in blindly adhering to old contract templates. It is also an impressive demonstration of the existence of contract stickiness.

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[39] https://chicagounbound.uchicago.edu/cgi/viewcontent.cgi?article=6227&context=uclrev

Gillian K. Hadfield: Remaking the Rules for the 21st Century.

Academic and author Gillian K. Hadfield is a Faculty Affiliate at the Vector Institute for Artificial Intelligence in Toronto and the Center for Human-Compatible AI at the University of California, Berkeley. She is also teaching Legal Design Lab (with Dan Ryan) at the University of Toronto. Her research is focused on the need to reform and redesign legal systems in market democracies. Hadfield is a pioneer in pushing the current legal system into the 21st century.

Hadfield's book, ***Rules for a Flat World***[40], goes into great detail on why we need to "radically rethink" today's legal system in the face of globalization, digital technology and artificial intelligence. She states, "We are at an inflection point in the evolution of legal systems, facing the need to reinvent how we do law."

Hadfield says the existing regulatory structures for law "inhibit innovation in law to meet the needs of the new global economy and the potential for more market-based methods of providing legal inputs to support economic growth, democracy and global integration." In her 2017 book she writes, "To increase our capacity to invent and build the legal infrastructure we need throughout the complex global economy—in both rich and poor places—we have to think differently about how we produce rules and rule systems."

Current approaches to law are "making matters worse," she continues. She points out that the problem is not that we have too much law, but rather "the way we have gone about producing law for the last few hundred years—exclusively through state-controlled political institutions such as legislatures, state-run courts, and lawyer-controlled legal professions—is starting to max out on its ability to manage the burgeoning economic and social complexity to which it has played midwife."

Hadfield argues why the existing legal system is no longer sustainable in today's globalized and digitized market. The challenges with globalization and technology are well-documented, and Hadfield's research brings a unique twist by focusing on how the legal system is hindering progress of a modern economy.

Hadfield's work focuses on making law "more accessible, effective, and capable of fulfilling its role in balancing innovation, growth, and fairness." Lawyers often have a strict black and white approach when it comes to supplier relationships. The ones with the most power typically use their muscle to tip legal terms and conditions to their benefit (e.g., sorry supplier, your work is work for hire and I own the Intellectual Property and we have a 30-day termination for convenience).

A favorite area of interest in Hadfield's work is around how social norms play a role in the legal system. Hadfield writes, "Social norms are not the product of an enterprise. They are organic: they emerge and adapt in processes that may be hidden and hard to control. There may be social entrepreneurs who try to establish a social norm, by preaching from pulpit or billboard or blog, for example. But there is no single recognized process that everyone understands is the way that a norm becomes the norm. It is when norms become the subject of a deliberate project intended definitively to designate a particular set of rules, including the rules for making rules, as 'law' that social norms can become law."

This is where the Vested business model for relational contracting is important, because Vested embeds social norms, or guiding principles, into the contract. In effect, what are commonly referred to as "unofficial rules," are made law. Would lawyers or a legal department come up with that innovation? Perhaps in some cases, but as Hadfield writes, "Innovation requires deep knowledge, but it also requires fresh eyes, to see a problem in a new light and to fashion a new way of resolving it."

Advice to Practitioners: Build a stable legal platform that accounts for increasing complexity and makes room for innovation. Find creative ways to manage enormously challenging, costly and dynamic strategic relationships. Don't necessarily hire more lawyers. Rather harness markets for legal innovation.

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[40] https://www.amazon.com/Rules-Flat-World-Invented-Reinvent/dp/0199916527/ref=tmm_hrd_swatch_0?_encoding=UTF8&qid=1674592146&sr=8-1

Jane Mansbridge: Coercion is Serious Business

Jane Jebb Mansbridge is an American political scientist. She is the Charles F. Adams Professor of Political Leadership and Democratic Values in the Kennedy School of Government at Harvard University. Mansbridge previously taught at the University of Chicago and Northwestern University.

What can a professor who teaches democratic theory tell us about collaborative, non-coercive business, and outsourcing relationships? Mansbridge, in three important white papers and articles, "Taking Coercion Seriously," "Conflict and Self-Interest in Deliberation," and "What Does the Ideal of Deliberative Democracy Demand?" unveils some vital insights about the best ways to approach deliberations – or negotiations – in the most cooperative and non-coercive manner. While her focus and teaching is on Western democratic deliberations, her ideas also apply to business negotiations.

For example, she says that a commitment among parties should acknowledge that some degree of self-interest will be present. While self-interest plays a role, "deliberation should, ideally, be open to all those affected by the decision," she says. Fairness and equality are key.

Mansbridge says, "The participants should have equal opportunity to influence the process, have equal resources, and be protected by basic rights. In the process of mutual justification, participants should treat one another with mutual respect and equal concern. They should give reasons to one another that they think the others can comprehend and accept. They should aim at finding fair terms of cooperation among free and equal persons. They should speak truthfully. The criterion that most clearly distinguishes deliberative from non-deliberative forms of democratic decision is that in the regulative ideal, coercive power should be absent from the deliberation. Participants should not try to change others' behavior through the threat of sanction or the use of force."

Once parties have gotten to yes in a contract negotiation, some real work and some real tools are needed to forge a lasting, collaborative, shared value partnership. The Vested *Getting to We* process changes the goal of the negotiation from the deal itself to the relationship. Following this negotiation process helps companies change how they view the relationship. This is done through an approach based on trust, reciprocity, autonomy, honesty, equity, loyalty and integrity.

These principles drive collaborative behaviors. And it's equally true for existing relationships and for new ones. Therefore, to ensure a constant state of collaboration each party is responsible for following the principles, constantly. For example, if the parties take seriously the principle of loyalty, they will look out for the interests of the relationship, which means that some very common ways in which companies negotiate become unacceptable.

Coercion is a tactic that violates the principles. Coercion is any threat of penalty that induces one partner to agree in order to avoid unpleasant consequences. Mansbridge says that by responding to the threat, however, the partner is acting against its self-interest.

One way that parties might try to coerce each other is by threatening to leave the relationship: a powerful buyer might coerce a supplier to lower its prices by threatening to switch the work to the supplier's competitor. This type of coercion is not in the best interest of a collaborative relationship seeking to achieve a shared vision, and it puts the economics of the deal or pending deal out of balance.

But Mansbridge also raises an interesting philosophical counterpoint about coercion and deliberations: "We need coercion in order to make our institutions work. The best kind of coercion is the most legitimate coercion – the efficient kind of coercion and democracy is the best legitimizer we've found so far."

Advice to Practitioners: Coercion is a word with bad connotations, but a certain amount of "convincing" is often needed in order to move forward—as long as it is not based on muscular self-interest, or power-plays, but rather on a legitimate commitment to move the relationship forward, based on trust and integrity.

Lisa Bernstein: Contract Theory

Lisa Bernstein is a lawyer and law professor. She currently serves as the Wilson-Dickinson Professor of Law at the University of Chicago Law School. Her work is in the field of law and economics, and she is the co-editor of the textbook Customary Law and Economics.

Lisa Bernstein is a renowned lawyer and law professor who has made significant contributions to the field of law and economics. Her work primarily focuses on the study of contract law, which is concerned with the legal agreements that govern business transactions. She has developed several theories that have helped shed light on the complex nature of contracts and the ways in which they affect economic activity. We will explore some of these theories below:

One of Bernstein's most important contributions to the field of contract law is her theory of "private ordering." According to Bernstein, private ordering refers to the various ways in which parties to a contract can set the terms of their agreement without government intervention. This can include negotiation, standard-form contracts, and other mechanisms that allow parties to tailor their agreement to their specific needs. Bernstein argues that private ordering is an essential component of contract law because it allows parties to achieve more efficient and effective outcomes than they could through government intervention.

Another important theory developed by Bernstein is her work on the role of social norms in contract law. Bernstein argues that social norms can play a significant role in shaping the behavior of parties to a contract. For example, if a particular industry has a norm of fair dealing, then parties to a contract in that industry are more likely to behave honestly and fairly in their dealings with one another. Similarly, if there is a norm against opportunistic behavior, then parties are less likely to take advantage of one another in their contractual relationships. Bernstein's work on social norms has helped to illuminate the complex ways in which social factors can influence economic activity. In the Vested methodology we take particular notice of Bernstein’s focus on social norms by incorporating agreed definitions of these into the actual contract document.

In addition to her work on private ordering and social norms, Bernstein has also joined may others in developing a theory of "contractual incompleteness." According to this theory, contracts are often incomplete because it is impossible to anticipate all of the contingencies that might arise in the course of a business relationship. As a result, parties must rely on "incomplete contracts" that leave many aspects of their relationship undefined. Bernstein argues that contractual incompleteness can lead to disputes between parties, as each tries to assert their own interpretation of the contract. However, she also suggests that incomplete contracts can provide an opportunity for parties to negotiate new terms and develop a more effective agreement over time.

Finally, Bernstein has also done significant work on the role of intermediaries in contract law. Intermediaries are third parties that facilitate transactions between buyers and sellers. Examples of intermediaries include brokers, agents, and market makers. Bernstein argues that intermediaries can play a significant role in reducing transaction costs and facilitating more efficient contracts. For example, intermediaries can help to match buyers and sellers, provide information about the quality of goods or services, and enforce contracts in cases of non-performance.

Advice to Practitioners: There is much we can take from Bernstein’s work, firstly ‘private ordering’ means the parties have the flexibility to “write their own contract” thus building in the flexibility to deal with the incompleteness that she also raises. A key part of a Vested contract is the Statement of Intent that codifies the social norms that the parties have agreed to which aligns well with Bernstein’s research. Finally, the Vested methodology uses independent third parties (Certified Deal Architects) to help the parties develop a contract that incorporates all of Bernstein’s thoughts on contracts.

Jeanne Brett: Dispute Resolution Strategies

Jeanne Brett is the DeWitt W. Buchanan, Jr. Professor Emerita of Dispute Resolution and Organizations. Professor Brett's research is in the areas of cross-cultural negotiations, the resolution of disputes, and the performance of multicultural teams. She is the author of numerous journal articles, negotiation teaching materials, and two award winning books: Getting Disputes Resolved with William Ury and Stephen Goldberg and the single authored Negotiating Globally. She has received numerous career awards: the David L. Bradford Outstanding Educator Award in Organizational Behavior; the Academy of Management Outstanding Educator Award; the Clarence L. Ver Steeg Graduate Faculty Award, and the International Association for Conflict Management Lifetime Achievement Award.

Not all contractual agreements work the way the parties perhaps intended and in these circumstances a dispute may occur. Jeanne Brett has researched the effectiveness of different dispute resolution mechanisms in the context of contractual relationships. She has shown that the choice of dispute resolution mechanism can have a significant impact on the success of the contractual relationship and that certain mechanisms may be more effective than others depending on the nature of the relationship and the type of dispute. For example, she has found that mediation is often more effective than litigation in resolving disputes in ongoing relationships, while arbitration may be more effective in resolving disputes involving one-time transactions.

Brett's research has included studying the use of alternative dispute resolution mechanisms and the development of contractual provisions that facilitate dispute resolution. This aspect of her research is significant for the Vested approach to contract formation as a good deal of time is put into the creation of governance processes that keep the parties aligned and act proactively to prevent disputes breaking out. The Vested approach also seeks to create escalation processes that ensure the right people can come together to solve an issue before it turns into a full-blown dispute.

Another important contribution of Brett's research is her work on the role of cognitive biases in contract design and dispute management. She has shown that cognitive biases can lead to suboptimal contract design and can also influence the way that disputes are managed. For example, she has found that the availability bias can lead to the overestimation of the likelihood of certain types of disputes, which can result in the inclusion of overly complex dispute resolution mechanisms in contracts. Her work on cognitive biases has helped to raise awareness of these issues and has led to the development of new strategies for mitigating the effects of cognitive biases in contract design and dispute management.

Another important contribution of Brett's research is her work on the role of gender in negotiation. Brett has shown that gender differences in negotiation behavior can lead to differences in outcomes, with women often receiving less favorable outcomes than men. However, she has also identified strategies that women can use to improve their negotiation outcomes, such as framing their requests in terms of shared goals and interests rather than individual gain. Again Brett takes a very Vested approach to overcoming the bias and power differences that can occur in cross gender negotiations.

Advice to Practitioners: We should all hope that the contracts we negotiate will run smoothly and that neither party will feel hard done by. In reality, many contracts will incur some form of dispute (even though only a small fraction end up in litigation). It therefore makes sense for those that are crafting agreements and contracts to take note of Jeanne Brett's findings and design in processes that avoid disputes where possible and if they do occur to ensure the most appropriate resolution mechanism is chosen. Finally it is always sensible to be aware of the cognitive biases that we or our partner might be suffering from when negotiating a contractual relationship.

Thomas Donaldson: Ethics and Contract Design

Thomas Donaldson is The Mark O. Winkelman Professor of Legal Studies & Business Ethics at the Wharton School at the University of Pennsylvania. He is an expert in the areas of business ethics, corporate compliance, corporate governance, and leadership. Donaldson has received a Lifetime Achievement Award, The Society for Business Ethics, 2019; Sumner Marcus Award, 2016 (Social Issues in Management Division of the Academy of Management); Aspen Institute's Pioneer Award for Lifetime Achievement, 2009; "Most influential 'thought leader'" in Ethisphere Magazine's ranking of the 100 Most Influential People in Business Ethics

While we all like to see ourselves as an ethical person we also face the reality that either our actions or those of our contractual partner may stray over the line. Thomas Donaldson has studied these ethical dilemmas as they relate to contracts. One of his key contributions to the field of ethics and contracts is his argument that contracting parties have a moral obligation to honor their contractual commitments and to act in good faith in their interactions with each other. He has also highlighted the importance of considering the broader social and environmental impacts of contractual relationships and has argued that contracting parties have a responsibility to consider the impact of their actions on a range of stakeholders, including employees, customers, and the broader community.

Donaldson has also conducted research on the ethical implications of specific contractual provisions, such as confidentiality agreements and non-compete clauses. He has argued that these provisions can have both positive and negative ethical implications, depending on the specific context of the contractual relationship. For example, he has shown that confidentiality agreements can be an important tool for protecting intellectual property rights, but that they can also be used to conceal unethical or illegal behavior. This risk is a particular problem when the powerful party imposes their 'standard' contract template on the other party. Under the Vested methodology we always seek to have the final agreement to come from a process of co-creation thus ensuring the interests of both parties are considered in the drafting process.

Similarly, to Jeffrey Pfeffer, Donaldson has looked at power imbalances and ethics in contracts. He has argued that power imbalances can create ethical challenges for contracting parties, particularly when one party has significant bargaining power over the other. He has also shown that power imbalances can lead to unethical behavior, such as the exploitation of vulnerable parties or the use of coercion to secure contractual commitments. His work on power imbalances has helped to raise awareness of these issues. Again, the Vested methodology seeks to balance these risks by aligning the interests of the parties and highlighting the benefits to the powerful party that can be gained through collaboration.

Finally, Donaldson takes a view on the social norms that should apply in relation to the creation of contracts. These social norms were defined by Donaldson as:

- All humans are constrained by bounded moral rationality. This means that even rational persons knowledgeable about ethical theory cannot always divine good answers to moral problems without being acquainted with community-specific norms.
- The nature of ethical behavior in economic systems and communities helps determine the quality and efficiency of economic interactions. Higher quality and more efficient economic interactions are preferable to lower quality and less efficient economic interactions.
- All other things being equal, economic activity that is consistent with the cultural, philosophical, or religious at attitudes of economic actors is preferable to economic activity that is not.

Advice to Practitioners: We cannot successfully craft a good agreement with our chosen partner without considering ethics. Firstly we must negotiate and act after the agreement is signed in good faith. Next we must be careful of standard contract template and their ethical considerations, And, finally we should consider Donaldsons three social norms, particularly as they relate to the efficiency of the economic outcomes.

Kathleen M Eisenhardt: Flexibility in Contracts

Kathleen Marie Eisenhardt (born 1947) is the Stanford W. Ascherman, M.D. Professor and co-director of the Stanford Technology Ventures Program at Stanford University. She is also a corresponding fellow of the British Academy, having been elected in 2016.. Her publications include "Simple Rules: How to Survive in a Complex World" (Houghton Mifflin Harcourt) which explores how simplicity tames complexity in business, life, and nature. She is also co-author (w/Shona Brown) of "Competing on the Edge: Strategy as Structured" Chaos (Harvard Business School Press).

Kathleen Eisenhardt is a renowned management theorist who is known for her work on strategy, innovation, and organizational design, particularly in the area of Strategic Alliances. One of her notable contributions to the field of management is her research on flexible contract design. This is a contractual arrangement that allows parties to adjust the terms of the contract based on changing circumstances or situations. In other words, it is an agreement that provides for adaptability and flexibility in response to uncertainty, complexity, and changes in the environment. Flexible contract design is particularly important in dynamic and rapidly changing environments where the future is uncertain, and where traditional, rigid contract structures may not be suitable.

Eisenhardt argues that flexible contract design is essential for managing strategic alliances, joint ventures, and other collaborative partnerships. These types of arrangements involve multiple parties with different objectives, interests, and cultures, which can create challenges and tensions. A flexible contract design can help to address these challenges by enabling the parties to modify the terms of the contract to reflect changes in the environment, circumstances, or objectives.

Eisenhardt has identified three key elements of flexible contract design: simplicity, adaptability, and trust. Simplicity refers to the need for a clear, concise, and easily understandable contract that sets out the core objectives, roles, and responsibilities of each party. The contract should be simple enough to be easily modified as circumstances change, but not so rigid that it becomes difficult to adapt. Adaptability refers to the need for a flexible contract structure that allows parties to modify the terms of the agreement as circumstances change. This can involve the inclusion of clauses that allow for renegotiation, termination, or modification of the contract. Finally, trust refers to the need for a high level of trust and collaboration between the parties to the contract. Trust can be built through open communication, mutual respect, and a shared commitment to the success of the partnership.

The theories developed by Eisenhardt resonate with the Vested methodology and support the approach we take to the creation of a Vested agreement. One of the key tenets of Vested is that the parties negotiating an agreement must recognize that once the contract has been signed “business will happen”. It is therefore important to take a leaf out of Eisenhardt’s book and ensure that the contract includes the ability to be flexible and supports the creation of trust. The way that we do this in creating a Vested agreement is we focus on the relationship first, the opening pages of the agreement focus on a shared vision and a common understanding of what is to be achieved. This builds and maintains trust. The next element is to avoid complex legal jargon, write the contract in plain language, thus keeping it simple. Finally by using a contract design process where much of the contents are contained within schedules, which are much easier to modify, the contract maintains a high degree of adaptability.

Advice to Practitioners: If you are faced with a complex and changeable environment where keeping aligned with the volatile nature of business is important then channel Eisenhardt’s theories and adopt the Vested methodology to create your contractual agreement. The ability to maintain ongoing alignment between the parties is a key source of success that practitioners will gain from adopting this approach.

PART FOUR:

The Social Science and Psychology of Sourcing

Why discuss psychology in contracting? The answer is simple. Psychology and behavioral economics focus on what motivates people to act in different ways. Simply put, it is easier to write good contracts when you understand what motivates people and how common biases can slip into decision making. In this chapter, we delve into the insights of psychologists and behavioral economists who have shed light on the complexities of human behavior and decision-making processes and their relevance to contract law and outsourcing.

In this section we navigate the intersection of psychology and contract law and profile a diverse array of scholars who offer valuable perspectives on trust, reciprocity, fairness, and the dynamics of interpersonal relationships. In essence, these writers put relationships into Relational Contracting and help us remember that it is people who negotiate and form contracts. Our work at the University of Tennessee on the Vested business model is as much based on the foundation of these writers as it is on the work of business, economic and legal scholars.

Art Markman: Looking Back to Go Forward

Art Markman is the Vice Provost of Continuing and Professional Education and New Education Ventures, and the Annabel Irion Worsham Centennial Professor of Psychology and Marketing at the University of Texas at Austin. He is also the editor of the journal Cognitive Science and consults regularly through his company Maximizing Mind.

In an article in his Harvard Business Review blog, Markman wrote that some time ago he was talking with a colleague about a project he was thinking about doing. “We were both solidly in the middle of our careers, but his evaluation of the possible project surprised me. He said, ‘There are a limited number of things that I’ll be able to say I’ve done in my career, and I’m just not convinced that this should be one of them.’”

What struck Markman about the conversation was that “it took a backward-looking perspective. That is, my colleague projected himself to the end of his career and looked backward over his contribution. In contrast, most people and businesses tend to be forward-looking. This strategy can be seen clearly in politics, where politicians often make decisions based on what will help them get re-elected.”

Markman addressed the duality of perspective. For example, younger people often regret actions taken that did not go well, while older people often regret actions they did not take. A backward-looking perspective highlights the missed opportunities and the things left unsaid or undone. He continued, “Throughout your career, there will be many potentially pivotal moments — times when you make decisions that might shape the next several years of your life. In these moments, there is a tendency to be risk-averse. People shy away from opportunities that might go wrong for fear that they will regret failing.”

Markman's ideas strongly apply to the business world and how we structure outsourcing deals. Taking the time to add perspective to your outsourcing planning is an important element in building a collaborative partnership because the decision to outsource is often described as a “pivotal moment," to use Markman’s words. The idea of basing an outsource decision on what you and your partners hope to say about the outcome when you look back on the entire endeavor is attractive. This can help to build governance structures that guide both parties to behave in a long term and more united fashion

The University of Tennessee’s Vested approach employs a backward-looking approach much like Markman's friend because it starts with clearly defining the goals of both parties, which we call Desired Outcomes. Companies project the future and then work backwards to craft a deal structure that incentivizes the service provider to achieve those Desired Outcomes.

Finally, Markman offers sound advice when it comes to reflecting on your performance: “At least once a year, though, it is important to take stock of how you are progressing on your larger goals. An organization that consistently looks back on the present from the desired future has an excellent chance of achieving those goals.”

We all know how easy it is to fall into the day-to-day minutia of business. The best way to reflect on the performance of an outsourcing relationship is through a sound governance structure. My co-authors and I provide some guidance on this in my second book, The Vested Outsourcing Manual. We recommend doing monthly strategic reviews in the first year of an outsourcing relationship and at least quarterly after that. We also suggest adding further perspective by leveraging a tiered management structure.

Advice to Practitioners: As we often say: business happens! Take a breath and begin looking back to go forward. It is a valuable exercise both on a personal and outsourcing level. What is particularly powerful about setting long term goals is that it allows decisions to be matched against these goals which can speed up decision making and avoid wrong turns along the way.

Wayne Dyer: The Courage to Change

*Wayne Dyer is a best-selling author on self-development and is also known as the "father of motivation." He holds a doctorate in educational counseling from Wayne State University and was an associate professor at St. John's University in New York. In his book, **The Power of Intention**[41] (2005), Dyer explores intention—not necessarily as something you do, but as a form of energy and change that's actualized and controlled through creativity, expansion, receptivity and kindness.*

Outsourcing involves major changes in your business model, your teams, your approach to core and non-core business lines and cultural mindsets. That aspect of the outsource decision – change – is inherently psychological because when you come right down to it, it's always about your people, their relationships and attitudes, and the way they adjust to new thinking and new patterns that will make or break an outsourcing partnership. As Dyer is quoted, "If you change the way that you look at things, the things you look at change."

The Vested model embraces those qualities in order to change the thinking and create a new dynamic between the parties in an outsource relationship. The Vested approach is based on creative collaboration and trust, receptiveness to change, expansion through innovation and incentives, and kindness by "playing nice."

"If you're always in a hurry, always trying to get ahead of the other guy, or someone else's performance is what motivates you, then that person is in control of you," Dyer says. And relationships based on obligation and control "lack dignity." Playing nice and working jointly on intentions, objectives and desired outcomes to achieve the win-win requires a transformation—a change—in thinking.

The Jaguar/Unipart relationship provides a great example of the power of change—and the courage to implement it. Jaguar began working with Unipart almost 25 years ago. The initial focus of the outsourcing effort was aftermarket auto parts fulfillment in the United Kingdom. When Sir Nick Scheele took over as Jaguar's CEO in 1992, the two companies had already established a track record of moderate success.

But after recognizing that the relationship was not working as well as it could and that a change was needed, he had an informal dinner discussion with Unipart's CEO, John Neill. The goal was to discuss how the companies could improve the business model while also driving more positive benefits for Jaguar and Unipart. These discussions ultimately led to the creation of a Shared Vision statement that not only strengthened the personal relationship between the two leaders; it led to a deeper understanding of each other's business model and how to leverage that for maximum gain.

It has been a highly successful collaboration: When Unipart entered into the contract over 20 years ago, Jaguar ranked ninth in the J. D. Power and Associates survey for Customer Satisfaction. In 2008, it moved to number 1, passing Lexus, BMW, and Mercedes Benz and has maintained that spot ever since.

Which brings us back to Dyer's quote at the beginning – changing the way you look at things will necessarily change those things. The trick is to handle that change with care, collaboration—and courage.

Advice to Practitioners: As Dyer says, "Our intention creates our reality." That statement is equally true for people in their personal lives and in their business relationships. Documenting a shared 'intention' will help communicate that goal and help the parties keep focus on it. The Vested 'Statement of Intent' aims to exactly achieve Dyer's recommendation. Because the vision and behaviors are mutually developed and shared the challenges and resistance to change can be better managed in a collaborative way. The parties become more receptive to change and improvement because of the shared 'intention'.

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[41] https://www.amazon.com/Power-Intention-Dr-Wayne-Dyer/dp/1401902154/ref=tmm_hrd_swatch_0?_encoding=UTF8&qid=1674677455&sr=8-1

Kahneman and Tversky: Cognitive Biases

Nobel laureate Daniel Kahneman, professor emeritus of Psychology at Princeton University, is famed for his psychological research into economic science and behavioral economics, laid the foundation for the field of research known as cognitive biases. Amos Nathan Tversky was an Israeli cognitive and mathematical psychologist and a key figure in the discovery of systematic human cognitive bias and handling of risk. Six years after Tversky's death in 1996, Kahneman received the 2002 Nobel Memorial Prize in Economic Sciences for the work he did in collaboration with Amos Tversky.

Nobel laureate Daniel Kahneman and his colleague Amos Tversky challenged traditional economic theory that people make rational choices based on self-interest. Their research showed that people often fail to fully analyze situations where they must make complex judgments, and instead make decisions using rules of thumb rather than rational analysis, based on factors like fairness, past events, and aversion to loss. They also found that people's decisions can be swayed by how a given situation is framed.

These cognitive biases also plague businesses, resulting in ineffective decision-making. One example is the resistance to improving the quality of the decision-making process because people feel threatened. Businesses often fear change and cling to why they need to continue doing things the same old way they have always done them. Vested's 10 Ailments that can plague business and outsource deals, such as the Junkyard Dog Factor and Measurement Minutiae, are examples of how cognitive biases can impede effective decision-making in business.

Cognitive biases in business can be broadly placed into two categories: information biases that include the use of heuristics, or information-processing shortcuts, and ego biases that include emotional motivations and social influences. These biases can lead to problems like the failure to make slow and deliberate decisions, the assumption that the most obvious decision is the best decision, the use of too narrow an approach in making a decision, and the focus on information that affirms beliefs and assumptions.

Other harmful biases include the inertia bias, which causes people to think, feel, and act in ways that are familiar, comfortable, predictable, and controllable, and the myopia bias, which causes people to see and interpret the world through the narrow lens of their own experiences, baggage, beliefs, and assumptions. Ego biases like the shock-and-awe bias, overconfidence effect, optimism bias, homecoming queen/king bias, and force field bias, also contribute to bad decision-making.

In today's volatile global economic climate, outsourcing decisions are highly complex and uncertain, especially where one side or the other acts with self-interest, inflexibility, and/or incomplete knowledge of the enterprise or problems. Irrational or at least ineffective behavior and outcomes are almost guaranteed in those instances.

In conclusion, Kahneman and Tversky's work has highlighted how cognitive biases can affect decision-making in all aspects of life, including business. By being aware of these biases, businesses can take steps to improve their decision-making process and avoid the pitfalls of irrational or ineffective behavior.

Advice to Practitioners: So, what can you do about cognitive biases that inflect your organization? How often have you sat in meetings where some, or all, of those biases were on display? Taylor says there are ways to fight through the bias thicket. His tips include:

- Be aware that cognitive biases exist; use your understanding of them to ask the right questions.
- Collaboration: the best way to recognize and mitigate cognitive biases.
- Turn on the cognitive bias radar.
- Establish a trusting, disciplined and consistent framework and process for making decisions.

Daniel Kahneman and Amos Tversky: The Impact of Fallacies.

Daniel Kahneman is an Israeli-American psychologist and economist notable for his work on the psychology of judgment and decision-making, as well as behavioral economics, for which he was awarded the 2002 Nobel Memorial Prize in Economic Sciences. Amos Nathan Tversky was an Israeli cognitive and mathematical psychologist and a key figure in the discovery of systematic human cognitive bias and handling of risk

Daniel Kahneman, a Nobel Prize-winning economist and author of the best-selling book "Thinking, Fast and Slow," is a prime contributor to the field of behavioral economics. Together with his colleague Amos Tversky, Kahneman conducted a variety of experiments that explored the nuances and depth of why humans suffer from bounded rationality. Their research has changed the way we think about rationality and how we make decisions.

Classical economics assumes that humans are rational and selfish in their decision-making, but prospect theory, developed by Kahneman and Tversky, presents an alternative view. Their empirical evidence showed that when making choices, humans do not assign value to things in absolute terms, but always with a reference point. They also found that humans suffer from loss aversion, meaning they dislike losing more than they like winning.

Kahneman and Tversky discovered several other ways that the human mind works differently from the assumptions of standard economic theory, such as cognitive biases and particularly fallacies. In the context of relational contracting, three fallacies or cognitive biases are of particular interest: the planning fallacy, probability neglect, and the self-serving bias.

The planning fallacy is the tendency for humans to be overconfident in their mental capabilities and to think that they understand the past better than they do. This tendency for simplicity of the human mind "makes us see the world as more tidy, simple, predictable, and coherent than it really is," writes Kahneman. This illusion leads to overly optimistic forecasts and predictions about the future, what Kahneman and Tversky called the planning fallacy. This illusion is largely responsible for the contracting paradox, where planning is necessary, but humans are much worse at planning than they think.

Probability neglect is the failure to assess risks properly, which is a function of the likelihood of something happening and the negative consequences of it happening. Despite the importance of probabilities in assessing risks and outcomes, people often violate normative decision-making rules. Small risks are either entirely neglected or significantly overrated. For instance, individuals may fear a 1% chance of contamination as much as a 99% chance. A contracting professional must assess risks and find ways to deal with them, but many are not good at assessing risks objectively.

The self-serving bias is the tendency to interpret events in a way that favors one's interests or beliefs. It is a cognitive bias that can lead to distorted thinking and decision-making, especially in the context of contracts.

Kahneman and Tversky's contributions to behavioral economics have shown that humans are not as rational as classical economics assumes. Humans suffer from cognitive biases and fallacies that affect their decision-making, especially in the context of contracts. By understanding these biases and fallacies, contracting professionals can make better decisions and avoid the pitfalls of bounded rationality.

Advice to Practitioners: To overcome the planning fallacy, practitioners should seek objective data and involve diverse perspectives in the planning process. To address probability neglect, practitioners should assess risks more objectively and consider the likelihood and consequences of various outcomes. Overcoming the self-serving bias, practitioners should approach the contract negotiation with transparency and fairness in mind, avoiding any potential conflicts of interest. In addressing the latter point consider bring in an independent third-party to help the parties surface any self-serving mindsets that might be hiding.

Clay Shirky: Sharing Changes Everything

Clay Shirky is Associate Professor at the Arthur L. Carter Center of Journalism in FAS and Associate Arts Professor in Tisch School of the Arts' Interactive Telecommunications Program at New York University. Before joining NYU's full-time faculty in fall 2004, he was a partner at an international investment company, and was the original Professor of New Media at Hunter College. Shirky is a faculty associate at Harvard University's Berkman Center for Internet and Society, and was the 2010 Edward R. Murrow Visiting Lecturer at Harvard's Joan Shorenstein Center on the Press, Politics, and Public Policy.

Clay Shirky, New York University professor, author, and a leading thinker on the effects of the internet on society, delves into the disruptive power of technology and collaboration on how people live and work.

Born in 1964, Shirky grew up with the cyber age—he's been writing about the internet since 1996. He's a deep thinker about it, as reflected in two of his books, ***Here Comes Everybody: The Power of Organizing without Organizations*** and ***Cognitive Surplus: Creativity and Generosity in a Connected Age***. The titles explain a lot about the direction of his thinking.

In an interview published by the management consulting group McKinsey[42], Shirky noted that "sharing changes everything." He studies the way people collaborate because "when communications tools come along and they change how people can contact each other, how they can share information, how they can find each other—we're talking about the printing press, or the telephone, or the radio, or what have you—the changes that are left in the wake of those new technologies often span generations."

The thing he looks out for, he continues, "when any source of disruption comes along, when anything that's going to upset the old order comes along, is I look for what the collaborative penumbra is." Basically, how can collaboration be extended when something new and disruptive occurs.

The collaborative penumbra can work in seemingly opposite directions, in tight groups or virtually no groups at all: "You've got these collaborative environments where almost no one has to coordinate with anybody else. When I upload something to *Thingiverse*, or I make an edit on Wikipedia, it's not like I need anybody else's help or permission. So the collaborative range is expanding." Both work. "Tight groups have more resources, and loose groups can be much more loosely coordinated and operate on a much larger scale," he says.

"I think the people who think about collaboration want to know what's happening to it, and the answer is everything." Shirky's point is that when "communication is so abundant globally it may as well be free."

Shirky's work definitely resonates with us. And it's one of the primary reasons we made the strategic decision to make much of our work on the Vested methodology and business model "open source."

Vested has a variety of open-source tools available for individuals and organizations to learn about how the model works, both in theory and practice, and in tight groupings or in less formal or smaller group scenarios. The Vested library has an extensive catalog of case studies and white papers that present real-life examples of collaborative outsourcing under the Vested business model—all free downloads. There are also open-source online courses for those interested in learning about Vested and a variety of resources for understanding and assessing the collaborative business model. For example, there's a module on the Five Rules of Vested and various self-assessments to help in understanding the Vested mindset, including an Organizational Readiness Self-Assessment.

Advice to Practitioners: Keep in mind – everything is happening when it comes to collaboration and open sharing. Taking Shirky's approach into creating a contract will quickly take the practitioner down the path to a Relational agreement where the benefits will exceed those to be gained via traditional approaches

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[42] https://www.mckinsey.com/industries/technology-media-and-telecommunications/our-insights/the-disruptive-power-of-collaboration-an-interview-with-clay-shirky

Amy Edmondson: Psychological Safety in Business

Amy C. Edmondson is the Novartis Professor of Leadership and Management at the Harvard Business School, a chair established to "support the study of human interactions that lead to the creation of successful enterprises that contribute to the betterment of society."

People and businesses need to feel safe, both physically and psychologically; Amy C. Edmondson is doing important work in the realm of psychological safety. She is the author of ***The Fearless Organization: Creating Psychological Safety in the Workplace for Learning, Innovation, and Growth***[43]. The key to innovation, according to Edmondson, is the ability to attract and retain quality talent—"but what good does this talent do if no one is able to speak their mind?"

In her own words on YouTube, she defines psychological safety as a "belief that the workplace is safe for speaking up, with ideas, questions, concerns and even mistakes. It's a sense of confidence that your voice is valued." Briefly put, it's permission for candor, that the workplace is somewhere to count on all voices being heard "because you never know when you will have had the observation that someone else missed that will be mission critical."

A key word from the book title is "fearless." This is not about being 'nice', in fact psychological safety embraces both nice and not so nice ideas in order to get to the truth about operations, conflicts and innovation. The lesson for organizations is to instill an atmosphere and environment of trust that embraces all points of view. It's okay to have different viewpoints, as long as they are not critically toxic.

Edmondson notes, "Psychological safety in a psychologically safe workplace doesn't mean that all of your ideas will be applauded. It's certainly not permission to slack off, it's not a license to whine, it's not oversharing - we still want people to be thoughtful and considerate in sharing work-relevant content."

Psychological safety isn't necessarily an organizational goal. It's an aspect and means to attaining the goal, which is excellence. And the road is often bumpy. To navigate the journey, Edmondson provides some tips that provide a clear path forward to continuous learning and healthy innovation:

- Explore the link between psychological safety and high performance.
- Create a culture where it's "safe" to express ideas, ask questions, and admit mistakes.
- Nurture the level of engagement and candor required in today's knowledge economy.
- Follow a framework for establishing psychological safety in your team or organization.
- Abandon the "yes-man" approach to encourage creativity, clarify goals, achieve accountability, and redefine leadership.

In another book, ***Extreme Teaming***, written with Jean-François Harvey, Edmondson explores the rise of collaboration by teams of experts operating across different professions, organizations, and industries. The book has insights into the world of complex, cross-industry projects and the ways they must be managed.

In a third book, ***Teaming***, Edmondson says organizations thrive, or fail to thrive, based on how well the small groups within those organizations work. In most organizations, the work that produces value for customers is carried out by teams, and increasingly, by flexible team-like entities. "The pace of change and the fluidity of most work structures means that it's not really about creating effective teams anymore, but instead about leading effective teaming. Teaming shows that organizations learn when the flexible, fluid collaborations they encompass are able to learn."

Advice to Practitioners: Psychology safety means creating an environment for interpersonal risk-taking and ensuring team members have confidence their voice is valued. This demands organizations create a culture where team members will not be punished or humiliated for speaking up with ideas, questions, concerns or mistakes.

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[43] https://www.hbs.edu/faculty/Pages/profile.aspx?facId=6451

Paul J. Zak: Doing the Math on Trust

Paul J. Zak is the founding director of the Center for Neuroeconomics Studies, which investigates the neurophysiology of economic decisions. He is also a professor of economics, psychology, and management at California's Claremont Graduate University.

In a 2017 Harvard Business Review article, "The Neuroscience of Trust[44]," Zak asserts that his research has found that "building a culture of trust is what makes a meaningful difference. Employees in high-trust organizations are more productive, have more energy at work, collaborate better with their colleagues, and stay with their employers longer than people working at low-trust companies. They also suffer less chronic stress and are happier with their lives, and these factors fuel stronger performance."

Business leaders understand the high stakes of trust. He cited a 2016 global CEO survey, that found that 55 percent of CEOs think that a lack of trust is a threat to their organizations' growth. But getting from point A to point B in the trust growth continuum is the rub. In the HBR article, Zak articulates a "science-based" framework designed to help those CEOs deal with trust issues. His first step is to look at the science behind the framework.

In 2001 Zak (and the economist Stephen Knack) derived a mathematical relationship between trust and performance in a paper for The Economic Journal (2001, vol. 111, issue 470, pages 295-321). In the HBR article, Zak admitted he could not answer the most basic question: why do two people trust each other? "Experiments around the world have shown that humans are naturally inclined to trust others—but don't always. I hypothesized that there must be a neurologic signal that indicates when we should trust someone."

He began a long-term research program to discover more about that signal. It seems that in rodents a brain chemical called oxytocin had been shown to signal that another animal was safe to approach. "I wondered if that was the case in humans, too."

To prove that trust and oxytocin were linked a series of studies were carried out in which participants had blood samples taken immediately after they had made the decision to trust someone. The experiment also allowed for increasing levels of trust. The results proved Zak's hypothesis, that oxytocin was linked to trust and the more trust the more oxytocin was produced. This resulted in higher levels of happiness for the participants that had chosen trust.

The possibility that the link between trust and oxytocin being coincidental was also tested by administering synthetic oxytocin and observing how trusting the participants became, again a strong link was identified. Finally, to see if the trust and oxytocin link was evolutionary and universal, or a more recent phenomenon, similar experiments were carried out on tribes in the highlands of Papua New Guinea. The same results were found, trust created happiness across all experiments (for those with a statistical bent the correlation was very high at 0.77, a sufficient statistic).

In the HBR article, Zak distilled his findings into a list of management behaviors that can help facilitate trust:

- Recognize excellence.
- Induce "challenge stress."
- Give people discretion in how they do their work.
- Enable job crafting.
- Share information broadly.
- Intentionally build relationships.
- Facilitate whole person growth
- Show vulnerability.

"High-trust companies hold people accountable but without micromanaging them. They treat people like responsible adults," writes Zak.

Advice to Practitioners: Getting a handle on trust and how it works is a worthy exercise for any business striving to increase trust, collaboration, value and innovation throughout the organization.

[44] https://hbr.org/2017/01/the-neuroscience-of-trust

Ernst Fehr and Simon Gachter: Reciprocity

Ernst Fehr is Professor of Economics at the University of Zurich, Institute for Empirical Economic Research and a Core Member of the MacArthur Foundation Network on Economic Environments and the Evolution of Individual Preferences and Social Norms. Simon Gachter is Assistant Professor of Economics, also at the University of Zurich.

We have provided research supporting loyalty and equity as key social norms. A third crucial social norm is reciprocity. The key concept of reciprocity is to return an action in kind; an eye-for-an-eye, a tooth-for-tooth. It is common sense when you think of it; the way people treat us affects how we treat them should come as no surprise.

However, it goes against the teaching of much of the classical economic theory. Professor Ernst Fehr and his colleague Professor Simon Gächter share their insight on reciprocity in an article titled "Fairness and Retaliation: The Economics of Reciprocity[45]." Reciprocity means that in response to friendly actions, people are frequently much nicer and much more cooperative than predicted by the self-interest model; conversely, in response to hostile actions, people are frequently much nastier and even brutal.

In several experiments, Fehr and others have shown how strongly reciprocity and other social motives (in contrast to material motivates) drive people's actions. In one study, some groups of subjects acted as employers while other groups acted as employees. The purpose of the experiment was to find out how offered salaries and work efforts correspond. The employers were asked to offer a salary, and the employees were asked to respond with a voluntary work effort.

Three different salary arrangements were tried: a fixed salary, a salary with a salary reduction in case of failed performance, and finally a salary with a bonus for good performance. In all cases, the work efforts were chosen after the salaries had been offered and the employers had no opportunity to respond to the chosen effort levels. The effects of reciprocity were evident; the study revealed a direct correlation between an increase in salary offered and work effort provided in return. Another result was that when the economic incentives were framed as a bonus instead of as a salary reduction, work efforts offered were higher.

Fehr's research is just one of an abundance of research on the Ultimatum's Game, gift exchange games, and similar studies across a variety of countries and cultures. Regardless of culture, it is clear that social norms around fairness, power usage, and reciprocity strongly affect humans all over the world. The assumption that all Humans are pure egoists is simply false. But another conclusion is that not all Humans are the same; some are more egoistic or altruistic than others. Humans exist on called a motivation continuum from pure self-interest to pure altruism.

Fehr refers to the people lying on the right side of the continuum as Strong Reciprocators, whereas he calls the people on the left side Opportunists. In a group of people, we can predict that both Strong Reciprocators and Opportunists will exist. But who will have the upper hand? The answer depends on the context, not least on the rules of the game they play and other circumstances.

Advice to Practitioners: By writing a relational contract that sets the right rules for the game, the contracting professional can create a context in which the Strong Reciprocators will dominate, which will lead to significantly better results for everyone involved.

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[45] https://pubs.aeaweb.org/doi/pdf/10.1257/jep.14.3.159

Dan Ariely Co-Creation Builds Trust and So Does Sharing

Dan Ariely is the James B. Duke Professor of Psychology and Behavioral Economics at Duke University and a founding member of the Center for Advanced Hindsight. He does research in behavioral economics on the irrational ways people behave, described in plain language.

One of Ariely's findings has been described as the 'IKEA Effect'. This highlights how people that have been involved in the creation of a product, for example assembling an IKEA bookcase, value that product more highly than a similar 'expert built' product. This has led marketers to offer options where buyers can 'customize' their purchase, leading to greater satisfaction and customer loyalty. The Vested methodology harnesses that effect by having the parties to the agreement 'co-create' their contract. This leads to a greater commitment to the resulting agreement and delivery of results.

Dan Ariely also writes about the importance of establishing rules that can protect us from ourselves. He shares insights from his book, The (Honest) Truth About Dishonesty, where he examines how people deal with honesty and dishonesty in both personal and business interactions and explains how people can trick themselves into thinking they control their decisions. Ariely maintains that "most of us think of ourselves as honest, but, in fact, we all cheat." He asks why and when cheating occurs, whether it is useful, and how it can be discouraged.

In the realm of outsourcing and contracting, this leads us to the concept of "shading," developed by Oliver Hart, an economic theorist and a 2016 Nobel Laureate. Shading happens when one contracting party is not getting the expected outcome and feels that the other party has not acted reasonably to mitigate the losses. The aggrieved party reacts by withdrawing cooperation and proactivity going forward, causing significant inefficiency. The lesson is that those who use power and are opportunistic when negotiating will likely suffer later from reduced flexibility, a general reduction in cooperative behavior, and increased prices or lost contracts as business partners seek ways to get even.

Organizations often attempt to eliminate shading by writing a more 'bullet proof' contract. Don't do it! Rather, adopt a formal relational contract. A formal relational contract is still a legally enforceable written contract (hence 'formal'). The main difference is to keep the parties' expectations continuously aligned. When a pandemic or some other unexpected event happens, parties using a formal relational contract will not be surprised. They might be surprised by an unexpected issue such as a pandemic, but they will have anticipated that unexpected things can and will happen. By considering in advance how these grey areas will be managed in a fair and cooperative way issues of shading and dishonesty will be reduced.

Ariely's recent suggestion to organizations engaged with developing a fair agreement (Relational Contract) is to organize an in-person dinner with the joint team and order family style. Meals naturally bring people together, and the way they are served can affect cooperation among those at the table. Ariely pointed to a 2019 research study where students ate salsa and chips in pairs. Some duos were served from one bowl of chips and one bowl of salsa, while others were given separate bowls. Afterward, the students participated in a negotiation exercise. The pairs who had eaten from their own bowls went through thirteen rounds of negotiation, whereas those who had snacked from a shared bowl went through nine rounds. Working together is a mindset that can carry over from one task to another.

Advice to Practitioners: The Vested approach to developing a collaborative agreement is built around a process of 'co-creation'. By working together on a shared task will build and strengthen the relationship between the parties. And as a precursor to undertaking this process of co-creation take a leaf out of Ariely's book, and order in some chips and salsa to share! We also ensure we establish the relationship and trust first, before moving on to more challenging subjects such as money.

Vaia and Tommasetti: Connecting Governance with Trust and Commitment

Giovanni Vaia is Assistant Professor with tenure at Ca' Foscari University Venice at the Department of Management, where he teaches Business Administration and Global Sourcing. His interests include organization design with a specific focus on information systems, network governance and outsourcing, governance of information systems, IT Outsourcing. Aurelio Tommasetti was Rector of the University of Salerno from 2013 to 2019, and is a Professor of Business Economics at the University of Salerno.

Insightful governance is an essential part of business frameworks. Two scholars from Italy's University of Salerno have taken this idea a vital step forward. Giovanni Vaia and Aurelio Tommasetti are academics and the authors of a recent paper, "The Role of Contracts and Informal Relations in the Governance of IT Outsourcing Processes[46]." Vaia and Tommasetti write that "the governance of IT outsourcing processes needs the development of complex informal relationships in support of the contracts." They examine the concepts of "technological dynamism" and "market evolution" in the IT outsourcing sector. In a nutshell, they are writing about what should be radically common sense: that companies that outsource and their service providers face a high degree of uncertainty both in managing and innovating business services.

Their call to action is for adaptation and flexibility in IT outsourcing. Specifically, they advise companies to treat suppliers as strategic partners that are "pushing towards a harmonious and cooperative relationship based on trust and commitment." They go on to make this interesting and valuable observation: "The more the IT services are outsourced, the more long-term relations last, and the focus is on results and trust rather than on the contract."

Vaia and Tommasetti compare several cases of what they call "static" contract management, or "traditional classic contracting", with "dynamic" contract management, or dynamic contracting, basically describing a Vested approach: "The [dynamic] contract does not ever specify what it is necessary to do any time exactly, but it often defines only the aims to achieve and the procedures to follow (or the methods of revision of the main parameters which regulate the contract); the necessary adjustments due to events produced during the relation are regulated time by time, considering the whole development of the relation until the event (these adjustments often concern the amount rather than the price). Finally, the contract guarantees the observance of most contractual terms rather than the legal system, with the fixed incentives and any following agreements."

While the article is written in classic scholarly language (it's a tough read for the average practitioner), they describe a Vested collaborative and flexible framework. Simply put, a contract, whether it involves IT companies or other types of outsourcing endeavors, is more than a formal piece of paper with strict terms and conditions. It creates a relationship among the parties, including fewer formal interactions. This is very true in the realm of collaborative outsourcing, such as the Vested business model, where a partnership is based on a new mindset of trust and working together to share value.

Vaia and Tommasetti argue that trust allows companies to base the relationship on rules "characterized by flexibility and ability to adapt in order to manage the technological and business uncertainty, to start processes of knowledge exchange, to focus the growth of systems according to the real need of the company and the structural capabilities."

Advice to Practitioners: The role of "informal governance" becomes highly important because trust becomes the essential driver to help manage the relationship, something that a rigidly controlled contract can't easily do. Also of importance is the existence of a shared Statement of Intent, which keeps the parties focused on a common goal so that informal governance has a clear direction and purpose.

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[46] https://link.springer.com/chapter/10.1007/978-3-642-15417-1_12

Robert Kurzban – Why Everyone Else is a Hypocrite

Robert Kurzban, Ph.D., was an Associate Professor at the University of Pennsylvania in the Psychology Department. He is now an American freelance writer specializing in evolutionary psychology, and a proponent of evolutionary psychology as a key to understanding human behavior in all of its complexity.

It's an intriguing subject, made even more intriguing by the title of his first book, ***Why Everyone (Else) Is A Hypocrite***[47]. His point is that the key to understanding behavioral inconsistencies, both personally and in business, lies in understanding the mind's design. He explains: "The human mind consists of many specialized units designed by the process of evolution by natural selection. While these modules sometimes work together seamlessly, they don't always, resulting in impossibly contradictory beliefs, vacillations between patience and impulsiveness, violations of our supposed moral principles, and overinflated views of ourselves."

In a TAM talk in 2014, Kurzban noted that the poet Walt Whitman was correct when he said that we all "contain multitudes." This is not to say that we are all clinically schizophrenic, but we "contradict ourselves because we contain multitudes of specialized systems that are designed for different functions…and sometimes those functions come into conflict. For instance, the "PR" part of our brain can often compete with specialized adaptations and strategic thinking. This might explain why politicians are often perceived as inconsistent or hypocritical. In fact, he goes on to say that while we usually can recognize inconsistencies in others, we often cannot catch ourselves so easily in our own inconsistencies.

Kurzban's book posits that his modular, evolutionary psychological view of the mind "undermines deeply held intuitions about ourselves, as well as a range of scientific theories that require a 'self' with consistent beliefs and preferences. Modularity suggests that there is no 'I.' Instead, each of us is a contentious 'we'--a collection of discrete but interacting systems whose constant conflicts shape our interactions with one another and our experience of the world."

Kurzban is on to something here, especially if you consider the difficulties and competing interests (and personalities) involved in forging strategic relationships. It is one reason why contracts often get bogged down in extensive protective and restrictive liability and risk provisions in attempts to make them "bulletproof".

It is also why a "getting to we" mindset, embodied in the book Getting to We, is a way to take agreement negotiations beyond the typical I-win-you-lose strategy to a consistent and collaborative place grounded in essential norms or guiding principles. The Getting to We premise provides a template for alignment among the parties by basing their relationship on a clear, unambiguous foundation of common social norms. The six social norms, or core guiding principles, which are based on trust, apply Vested's "what's-in-it-for-we" (WIIFWe) business relationship approach and create a formal "Statement of Intent" that is embedded right up front into the contract – clearly setting out the intentions for how the parties should behave. The common set of principles--reciprocity, autonomy, honesty, equity, loyalty and integrity—drive cooperative, consistent and aligned behavior. When one party strays, they simply need to pull out the Statement of Intent and gently remind the other party they have agreed to a set of behaviors with the intent to keep the relationship fair and balanced.

Advice to Practitioners: Nothing is ever guaranteed in contract negotiations, but committing to these principles will nurture a partnership entity that can help the parties "evolve" their behavior. The creation of 'shared interests' avoids the friction that competing interests and personalities can bring to a negotiation.

[47] https://www.amazon.com/Why-Everyone-Else-Hypocrite-Evolution/dp/0691146748/ref=tmm_hrd_swatch_0?_encoding=UTF8&qid=1674767269&sr=8-1

Libby Weber: The Importance of Framing Your Contracts

Libby Weber is an Associate Professor of Strategy at The Paul Merage School of Business, University of California, Irvine. Her research examines how employees' perceptions and the many influences on them (including their identity, the way the company is organized, inherent cognitive biases, etc.) impact the company's performance by shaping employee decisions, contracts, exchange outcomes and relationships with other companies.

Weber promotes a way of thinking about contracts beyond their traditional "preventive" role of avoiding risk, and preventing breaches or opportunistic behavior. Her premise? Why not use contracts to promote cooperation, flexibility and creativity? The idea? "Frame" the contract using different words with a more positive nature with a "promotion-based" approach, while keeping the value of the contract the same.

In various papers and articles, she conveys that the same contract can be written to fit into two basic baskets – preventive-based and promotion-based. When you write a contract, you can pick the perspective of how you frame the agreement. The conventional approach is preventive-based, with a focus on risk shifting and protectionism. But, Weber's research shows this negative framing is not fit-for-purpose – especially in more strategic contracts where the parties need to have a cooperative environment promoting innovation and value creation. Per Weber, contracts not only "protect against exchange hazards, but also function as relationship management tools." The trick is to get the balance right in order to engender long-term trust.

In a 2011 article in the Academy of Management Review, "Designing Effective Contracts: Exploring the Influence of Framing and Expectations[48]." Weber (and USC professor Kyle J. Mayer) directly address the concept of how contracts can build (or prevent) trust within the relationship. Their argument? Contracts can be used more flexibly as tools to impact positively both the transaction and the relationship trust between the partners. Contract framing involves how the parties approach, view and implement the contract terms and the relationship. Is it transactional? Short-term? Based solely on costs? Performance-based? Risk-averse? Relational? In psychological terms framing creates different views of the deal, while the economics stay the same. In general, prevention contracts can act as substitutes for trust, Weber says, while promotion contracts act as complements.

Contract framing is an important aspect of laying the foundation for a future relationship. Weber points out "the framing of duration safeguards provides an excellent setting in which to examine how psychology can inform transaction cost economics." A promotion-framed contract is more likely to promote trust than a prevention-framed contract "by inducing creativity, flexibility, and collaboration and by generating fewer negative emotions that lead to an arms-length relationship."

Weber posits that trust is likely to develop when people attribute positive actions to parties' internal characteristics rather than to external sources, such as contractual safeguards. Using a formal promotion contract leads to more successful transactions and relationships – especially for relationships where the parties are seeking a collaborative relationship to drive innovation and where trust is essential. She challenges lawyers to open their minds to shifting to more promotion-framed contracts. She asserted that making the shift opens "new opportunities for firms to use contracts more effectively and not just as a legal hammer that results in distrust and negative expectations."

Advice to Practitioners: Weber and her co-authors are doing important work about the psychological impacts of contracts, which nicely complements our work on relational contracting. Shouldn't contracts be much more than hammers with legalistic safeguards? In fact, they are of better use to the parties when they are set up as the 'playbook' that will guide the creation of value for both.

[48] https://journals.aom.org/doi/abs/10.5465/amr.2008.0270

Kathleen Vohs: Thinking About Money Makes People Egotists

Kathleen Vohs, Distinguished McKnight University Professor and Land O'Lakes Chair in Marketing, works to understand and communicate the basics of how people think, feel, and behave in order to make sense of marketplace and organizational outcomes. Vohs's research specialties include self-control, the hidden costs of decision-making, the psychology of money, the difference between a meaningful and happy life, and heterosexual sexual negotiations. She has authored over 250 scholarly publications and has been the editor of 9 books.

Kathleen Vohs has contributed greatly to our understanding of human behavior. One of her most notable theories is that thinking about money can make people more selfish and self-centered. This theory has been supported by a number of experiments and studies and has important implications for understanding human behavior in a variety of contexts. Vohs's theory is based on the idea that money is a symbol of power and status in our society. When people think about money, they are reminded of their own power and status, and this can make them more self-centered and egotistical.

One of the best-known experiments supporting Vohs's theory was conducted in 2006. In this study, participants were asked to complete a series of tasks that involved thinking about either money or neutral objects. After completing these tasks, participants were then asked to rate their own performance and their own abilities. The results showed that participants who had been primed to think about money were more likely to rate themselves as having performed better and as being more skilled than those who had thought about neutral objects. This experiment suggests that thinking about money can lead people to overestimate their own abilities and to focus more on their own needs and desires. This is consistent with the idea that money is associated with power and status and that people who are focused on money are more likely to see themselves as powerful and important.

Another study conducted by Vohs and her colleagues looked at the effect of money on social behavior. In this study, participants were asked to think about either money or neutral objects and were then asked to rate their willingness to help someone in need. The results showed that participants who had been primed to think about money were less willing to help someone in need than those who had thought about neutral objects. This study suggests that thinking about money can make people more selfish and less concerned with the needs of others.

Vohs's theory has important implications for a variety of contexts, from personal relationships to business and finance. For example, it suggests that people who are focused on money may be less likely to form strong relationships with others, as they may be more self-centered and less concerned with the needs and desires of others. In the business world, Vohs's theory suggests that a focus on financial gain may lead to a number of negative outcomes, such as unethical behavior, short-term thinking, and a lack of concern for the well-being of employees and customers. By contrast, a focus on building strong relationships and creating value for others may lead to more positive outcomes in the long run.

Advice to Practitioners: Human behavior in the sourcing context is important and Vohs’s theories can help us to make better decisions and build stronger relationships with others. By recognizing the influence of money on our behavior, we can work to overcome its negative effects and focus on creating value for our organization and our suppliers. Under the Vested approach we leave the discussion of money until late in the process of creating the agreement and first concentrate on building the relationship as an ‘inoculation’ for the negative impact of thinking about money.

Kahneman, Thaler, and Knetsch – Misuse of Power and Fairness

Daniel Kahneman is an Israeli American author, psychologist and economist notable for his work on the psychology of judgment and decision-making. He is also known for his work in behavioral economics, for which he was awarded the 2002 Nobel Memorial Prize in Economic Sciences. Jack L Knetsch was a contributor to research in behavioral economics and taught at George Washington University and at Simon Fraser University in Canada. Richard H. Thaler is an American economist and the Charles R. Walgreen Distinguished Service Professor of Behavioral Science and Economics at the University of Chicago Booth School of Business.

Another way Humans lack economic rationality is shown by examining the use and abuse of power. A hardware store used its position of power (the customers' dependency on the hardware store for snow shovels during heavy snow) to extract more money from customers. Classical economic theory - and many contract writers - view this as uncomplicated. However, the Kahneman, Thaler, and Knetsch study is not uncomplicated. They note that from the Human perspective, "it is unfair for a firm to take advantage of an increase in its monopoly power." Again, the hardware store is acting in an economically rational way. But, in the eyes of the public, 76% of the respondents thought that the higher price was unfair and the store was abusing its power.

Behavioral economics studies such as those above do not in themselves refute the law of supply and demand. In the real-world hardware stores may still raise prices of snow shovels in response to increased demand after a snowstorm. Theoretically, they would do this if it would be economically beneficial, which is however long people still accept the higher prices and buy snow shovels.

It's one thing to feel you are treated unfairly. But Kahneman, Thaler, and Knetsch also proved that Humans would go so far as to act differently because they were treated unfairly. Humans will often retaliate and punish unfair behavior. Researchers have devised experiments such as the popular Ultimatum's Game, where two groups of people are divided into pairs, one being a Proposer and the other being a Responder. The Proposer is given a sum of money, say $1,000, and is asked to propose how the money shall be split between the Proposer and the Responder. If the Responder accepts the proposal, the money is split accordingly. If the Responder rejects, no one gets anything.

Again, classical economic theory has a clear answer and prediction: The Proposer will and should propose a $999/$1 split and the Responder will accept. The Proposer, acting rationally, has no reason to offer more than necessary and the Responder has no reason to reject since he/she will be one dollar richer than before.

Again, however, the predications of classical economic theory fail. A very common result in the Ultimatum's Game is a 50/50 or at least 60/40 split. The results also show that Responders typically reject an offer below a 70/30 split. This result is somewhat stunning since it means that people will punish what they perceive as unfair behavior, even if it is against their best economic interests. And a reason Proposers offer fair splits is because they anticipate this reaction.

This idea of unfairness is also central to the findings by Oliver Hart in his Nobel Prize-winning research, which identified that suppliers who felt that they had been treated unfairly by the customer would engage in ‘Shading’, that is, skimp on quality, put the B or even C team on the account and any other actions that were within the letter of the contract but not in the interests of the customer. Suppliers would do this even if there was no return to themselves.

Advice to Practitioners: The Ultimatum's Game has proven time and again that regardless of the culture, country, or the amount of money at stake - Humans punish unfairness despite the fact the decision can make one worse off.

Churchman, Rittel and Webber: The "Wicked" Problem

Charles West Churchman was an American philosopher and systems scientist, and a Professor at the School of Business Administration and Professor of Peace and Conflict Studies at the University of California, Berkeley. Horst Wilhelm Johannes Rittel was a design theorist and Professor of the Science of Design at the University of California, Berkeley, College of Environmental Design, Department of Architecture and Department of City and Regional Planning. Melvin M. Webber was an urban designer and theorist associated for most of his career with the University of California at Berkeley

Churchman first coined the term "wicked problem" in 1967 to describe complex, confusing, and contradictory problems that resist resolution. The term "wicked" is used to denote problems that are more diabolical in nature, as efforts to solve one aspect of a wicked problem can create more problems. In contrast to solvable problems, wicked problems are ill-formulated, have confusing information, involve multiple decision-makers with conflicting values, and have ramifications throughout the entire system.

In his article, "Dilemmas in a General Theory of Planning," Churchman named various properties that distinguish wicked problems from hard but ordinary problems:

- Wicked problems have no definitive formulation, and every wicked problem is a symptom of another problem.
- Every wicked problem is unique, and there is always more than one explanation for a wicked problem, with the appropriateness of the explanation depending greatly on the perspectives and values of those involved.
- Solutions to wicked problems are only good or bad, not true or false. The solution is largely a matter of judgment.
- There is no surefire template to follow when tackling a wicked problem; plus, solutions to wicked problems can generate unexpected consequences over time, making it difficult to measure their effectiveness.
- Those attempting to address a wicked problem must be fully responsible for their actions.

While wicked problems can be daunting, a Vested mindset can help define whether a challenge is ordinary or wicked and provide steps and mindsets for addressing the situation. For example, P&G's A.G. Lafley looked beyond the company's walls to produce highly profitable innovations that would drive value for both P&G and the parties bringing innovation to P&G.

Wicked problems often occur when organizations face constant change or unprecedented challenges, such as the challenge to innovate. Wicked problems occur in a social context, and the greater the disagreement among stakeholders, the more wicked the problem. Honesty in facing any problem, whether ordinary or wicked, is essential both personally and organizationally. Questions surrounding company and stakeholder compatibility and values, mainly deception and honesty, enter into the strategies for dealing with the wicked problem. Honesty in facing any problem—whether ordinary or wicked—is essential, both personally and organizationally.

In conclusion, while wicked problems are difficult, they can be addressed through an open and honest approach to problem-solving. As Churchman wrote, it is essential to be honest about the limitations of any solution, recognizing that the problem remains wicked even if progress is made in taming a particular aspect of the problem.

Advice to Practitioners: Be honest in the face of the wicked problem and not defensive. In a relationship built on trust and cooperation practitioners should not be afraid to bring in their partner to the problem-solving effort. Having two perspectives may very well identify a path forward that one cannot see.

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During Andrew’s career, he has worked across many regions, including involvement in the senior leadership of a multinational Asia Pacific business, as well as responsibilities for supply chains that spanned the globe. Organizations Andrew has worked for during his corporate career include General Motors, Kenworth Trucks, Nissan, AlliedSignal and a Honeywell Joint venture.

In recent years Andrew has focused on the area of relational contracting and negotiation support for organizations that need help in implementing these powerful approaches to creating value. As well as becoming a faculty member at the University of Tennessee, he is also a CDA Coach with the responsibility to develop prospective CDAs and assist Vested License Partners in their journey to becoming Centers of Excellence in their own right. Andrew is the founder and Principal of Collaborative Impact Advisory a boutique consulting business based in Australia. You can reach Andrew at andrew@ci-advisory.com

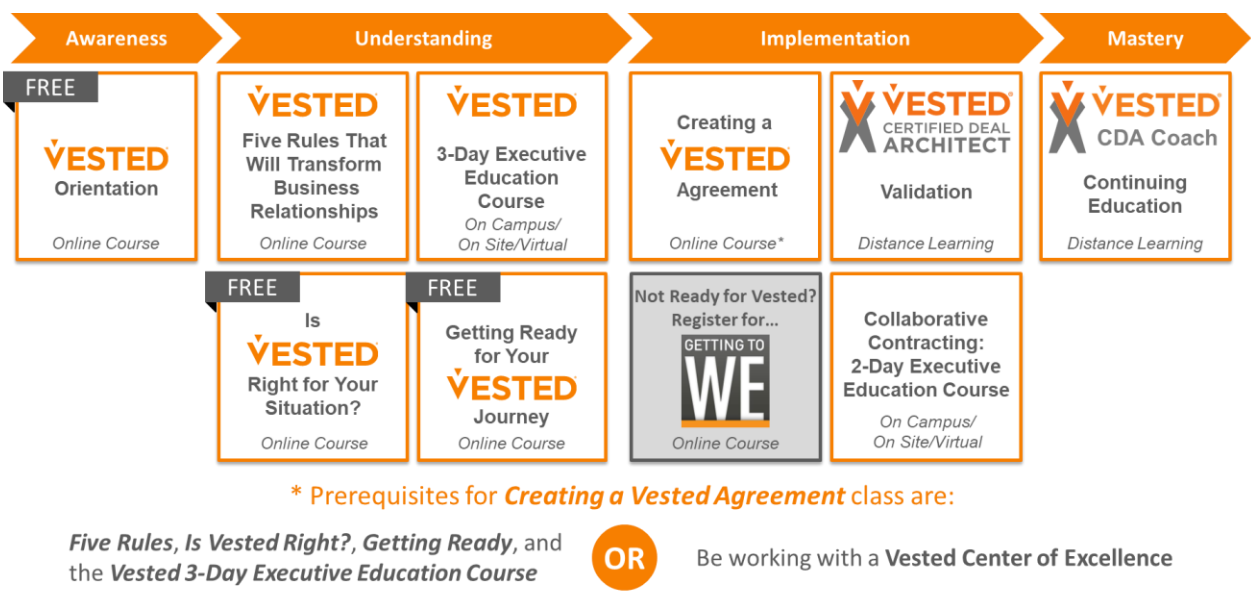
FOR MORE INFORMATION

The University of Tennessee is highly regarded for its Graduate and Executive Education programs. Ranked #1 in the world in supply chain management research, researchers have authored seven books on the Vested business model and its application in strategic sourcing.

WHY | WHAT | HOW | WHEN | NEGOTIATE THE RELATIONSHIP | TELLS THE REAL STORIES

We encourage you to read the books on Vested, which can be found at most online book retailers (e.g., Amazon, Barnes and Noble) or at [www.vestedway.com/books.](www.vestedway.com/books)

For those wanting to dig deeper, UT offers a blend of onsite and online courses including a capstone course where individuals get a chance to put the Vested theory into practice. Course content is designed to align to where you are in your journey ranging from Awareness to Mastery. For additional information, visit the University of Tennessee's website dedicated to the Vested business model at http://www.vestedway.com/ where you can learn more about our Executive Education courses in the Certified Deal Architect program. You can also visit our research library and download case studies, white papers and resources. For more information, contact kvitasek@utk.edu.



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