Vendor Relationship Management:
The Role of Shared History
And the Value of *Return on Trust*

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Executive Summary

Information technology outsourcing has become too important to ignore, or to delegate. The twin goals remain unchanged — (1) creating and retaining economic value over time while (2) controlling exposure and strategic risks — but the scale of both the upside gain and downside risk have become enormous. Fortunately, as we shall show in this article, setting strategy for outsourcing is principally a leadership issue, not a technical issue, and thus now falls squarely within executives' expertise and experience. Managing sourcing is principally about setting a strategy, based on economic objectives, communicating those objectives within and between firms, and managing psychology and expectations when the high economic stakes cause communications to break down. Successfully managing expectations and maintaining effective communications leads to trust, which, we have seen, produces great and measurable economic benefits in strategic sourcing relationships.

1. Introduction

Information technology outsourcing decisions have been transformed from technical, operational, or procurement decisions, to strategic decisions; that is, the decision makers are no longer information technology, operations, or purchasing personnel, but must be made by the most senior management team. Why. The benefits of well managed outsourcing of IT can be enormous, from cost savings, operating efficiencies, speed to market, or increased managerial focus on core activities. But the risks are enormous as well. All too frequently, outsourcing efforts fail, and the misunderstandings lead to litigation:

- **Failure to perform:** When Andersen Consulting failed to complete a $30 million installation of SAP core information systems for drug wholesaler FoxMeyer, FoxMeyer subsequently filed for bankruptcy. The bankruptcy trustee sued Andersen for $ 500 million, alleging that the bankruptcy resulted directly from the implementation failure, and further alleging that the failure was due to fraudulent substitution of key development staff with less qualified personnel.
- **Loss of control over intellectual assets:** When Priceline used Microsoft's Expedia travel site for rapid web entry, Microsoft allegedly learned the details of Priceline's patented "name your own price" auction and replicated it, breaking their cooperative marketing agreement and leading to ongoing patent infringement litigation.

- **Strategic holdup:** When an emerging market Eastern European bank became dependent upon a hardware vendor, who offered software that ran only on the recently purchased software, the vendor was able to reprice software by a factor of ten and slip delivery schedules by years. The bank had no alternative; having purchased the hardware, which was useless without software, and being dependent upon a sole vendor for software, the bank was subject to holdup, due to its strategic vulnerability. Ultimately this case, too, led to litigation over software contracting fraud.

Even in the absence of litigation, poorly conceived outsourcing decisions can have unforeseen implications. The recent merger of the London Stock Exchange with the Deutsche Börse is seen by many in the City of London as a friendly bailout or acquisition, rather than a merger; the reason London needed the merger is largely seen as an inability to modernize its operations, due to decisions taken years earlier to outsource both systems development and facilities management to IT consultants.

Moreover, as outsourcing becomes more prevalent, these problems become challenges for greater numbers of senior executives. Fortunately, as we will show below, the managerial skills needed to recognize and control risks are strategic rather than technical, they are not only the responsibility of senior management but within their current expertise. As importantly, with the exception of a few prominent cases of deliberate and premeditated contractual abuse, most outsourcing failures result from s self-reinforcing breakdown of communication, which can readily be managed by senior executives.

Outsourcing of strategic information services[1] is a large and growing business. The total volume of outsourcing contracts is hundreds of billions of dollars and is increasing. Likewise the, average contract size for facilities management contracts is several hundred million dollars and increasing as well. The contracts are large, and often are intended to remain in force for five, seven, or even ten years. They have high rewards. They also have risks that can jeopardize the economic well being of the client firm; increasingly, failure of outsourcing contracts is leading to litigation, which can threaten the existence of the vendor firm as well.

These contracts have often been treated as **information systems** expenditures, under the control of the chief information systems officer, or as **purchasing decisions**, under the control of senior purchasing officers. However, the tradeoffs between risks and rewards, and the need for long term relationship management, suggest that it would be more appropriate for control to reside with the CEO or with the head of appropriate strategic business units. Likewise, the strategic downside from mis-managed contracts — the opportunity cost of failure to meet a market demand, failure to preempt a competitor, failure to capture or hold a position in emerging ecommerce

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[1] Contracting for strategic outsourcing of information services can take multiple forms. The two that we have considered when drafting this article include facilities management and the development of strategic systems applications.

channels — suggests that this is moving from an information systems responsibility or a responsibility of contracting and purchasing units, to a responsibility of the CEO or of the head of the business unit.

Outsourcing of information services is frequently a very good idea. This outsourcing offers substantial opportunities for “gains from trade,” making both buyer and seller better off:

- For a variety of reasons, the vendor, (the seller of services, or the contract systems developer) can often operate or develop systems more cheaply than the client (the buyer and the user of contract services). This **cost reduction**, the difference between to cost to build internally and the cost to buy from the vendor, represents the first source of economic gain or economic surplus.
- Moreover, for a variety of reasons, the vendor can often develop systems with greater capability than in-house developers can provide, with a closer fit with future industry needs, and thus with greater value creation than available from systems developed. internally. This **value creation**, the difference between the value of systems that can be purchased and value of systems that would be developed internally, represents the second source of gain or of economic surplus.

Of course, if there were no offsetting costs or offsetting risks associated with purchasing information services, more systems and more services would be outsourced. These costs and risks effectively limit the expected gain from trade and thus limit the outsourcing of information services.

- The first limit on outsourcing is **transaction costs** — These include the various costs of coordinating interactions between different parties, translating or clarifying requirements, and developing and enforcing the contract.
- The second limit on outsourcing is **contractual risks** — These in general include the various forms of opportunistic behavior, such as cheating, deliberate underperformance, theft of expertise, and the exploitation of strategic dependence and vulnerability.
- The third limit on outsourcing is the **additional transaction costs undertaken to limit contractual risk** —These include activities such as monitoring and redundant testing, or the employment of contracting specialists and legal specialists.

It is our experience that virtual all major corporations mismanage the outsourcing of information services to some degree. In particular, purchasing agents and contracting specialists focus on **cost reduction**, rather than on **value creation**. Moreover, purchasing agents and contracting specialists focus on their own company’s cost reduction by focusing exclusively on the **contract price**, rather than on the total cost of the work to be completed, including transactions costs and contractual risks; as described above, these include the additional costs created by administering a contract with an outside firm and the risks and strategic vulnerabilities created by dependence upon an outside firm. All too often, focus on the concrete and explicit issues associated with contract **price** drives out discussion of the significant issues of contractual expenses and contractual risks.

Perhaps most importantly, purchasing agents and contracting specialists ignore the role of **shared history** in creating mistrust and increasing fear of contractual risk, which in turn increases transactions costs, and minimizes value creation. Indeed, if the perception of shared history becomes seen as sufficiently abusive, contracts may be terminated, losing all remaining gain from trade.

The focus of this paper is:

- On vendor **relationship management over time**, not solely on initial contracting
- On **value creation over time**, not solely on initial contract price reduction
- On the importance of **good history** in enabling value creation over time
- And on the **role of senior management** in obtaining these objectives and thus in obtaining long term gains from contracting

Senior management is critical in the following roles:

- Understanding the issues that determine the value of an outsourcing relationship
- Focusing employee activities on creating and obtaining economic gain through cost reduction and value creation, rather than simply wrestling over contract price
- Setting the right standards for subordinates to follow in negotiating sourcing contracts, once again focusing employee behavior on creating and retaining economic gain rather than simply contract price.
- And setting the right bounds on employee behavior in the negotiation and conduct of a contractual relationship; that is, making it clear that trust is fragile and, once broken, even by a single member of the team attempting to squeeze his way towards quarterly targets, is difficult to recreate.

That is, the focus of senior management will need to be on encouraging employee behavior to maximize the stability of relationships that create economic benefits, rather than driving employees to focus on short term power or immediate control over contract price.

Our central thesis is that focusing on initial power and initial contract price is not only unproductive, but counter-productive. That is, this misguided focus creates "bad history," which reduces value creation and maximizes transactions costs. This, in turn, limits the gain to both parties as thoroughly as it is possible to do so without actually terminating the contract. We first explore this thesis in detail, then provide some personal experiences with contracts where perceptions of history diverge, limiting the value to both parties. We conclude by showing how vendor relationship management can be seen as a sequence of diagnoses ("what is going wrong here?") and interventions ("how do I fix this?") over time.

There are, of course, contracts that are plagued by deliberate abuse, even fraud; those are not the focus of our discussions here. And there are contracts that are plagued by deliberate conflict of interest, such as subverting an employee of the client or vendor so that his actions are in the best interest of the counter-party, not of his employer. Once again, this is not the focus of our discussions here.

2. The Central Issues in Contracting: Creation and Distribution of Economic Gain

The central issues in contracting for information services are the **creation of economic gain** and the **distribution of this gain**. Creation of economic gain addresses the twin objectives of **reducing costs** and **creating additional value**.

- Economists have long focused on **creation** of gains from trade — that is, economists focus on maximizing economic efficiency by facilitating contracts that maximize the creation of economic surplus by directing work to the party most qualified to perform it. The question of value distribution or value retention (who keeps the value that has been created by trade) has been of minor interest to economists. Indeed, it has been studied principally because disputes over value distribution may prevent contracts from being agreed even when they would create economic surplus, and hence these disputes may interfere with economic efficiency.
- In contrast, executives have largely focused on **retention** of economic gain — a contract that creates enormous economic gain is of at best limited interest if none of it goes to you, your firm, or your shareholders.

A contract is simply an attempt to create a binding agreement, specifying actions that will achieve value creation and specifying the rules for value retention and value distribution. In the absence of uncertainty, there would be no need for relationship management: the terms of the contract would simply be observed for the duration of the contract, after which a new contract could be agreed. But, as we shall explore below, there is a high degree of uncertainty in information services contracting. We are seldom certain what our developer is actually doing, and we are seldom certain what our developer actually should be doing. This creates a fear of opportunistic behavior — when large sums of money and large deliverables of services are required, and when it is impossible to verify completely the quality of work or the amount of time required, there is always fear that the vendor is in some way cheating. This is the source of most contractual abuse, as explored in section 4.

Despite the fact that contracts are intended to be long term binding documents, contracts for information services outsourcing almost always require significant revisions during their lifetime. The need for contract revision, in the presence of fear of opportunistic behavior, is the principal reason why so many contracts experience bad history and bad relationship management. The contract will need to be changed due to unforeseen changes in the environment and unforseen changes either in requirements or in the most efficient way of delivering them. Change, when negotiated in an environment of uncertainty and incomplete observation, will often lead to fear that contractual abuse is occurring, especially given the scale of development and the size of price tag associated with information services contracts.

This fear will lead to actions that are misinterpreted by one or both parties, leading in turn to what we call **misaligned perception of history**. Misaligned perception of history increases stress and can end the creation of economic gain. Fear and distrust will all too often result in the same incident being seen very differently by client and vendor parties, increasing distrust and interfering with subsequent communications. When this distrust becomes sufficiently extreme it destroys the ability of the parties to work together, and therefore destroys the ability of the parties to create economic gain.

In the next two sections we address the theoretic perspectives needed to understand:

- The contracting process and the creation of economic gain through outsourcing
- The risks of contracting, and the factors that limit this economic gain

3. Contracting and the Creation of Economic Gain

3.1. Production Cost Advantages

An outsourcing vendor may enjoy production cost advantages for one or more of the following reasons:

- **Economies of Scale —** Being bigger makes it possible to do things more cheaply.
- **Economies of Scope —** Doing several related things makes it possible to do each more cheaply.
- **Economies of Specialization —** Doing only one thing makes it possible to do it well, and thus to do it more cheaply.

Economies of **scale** in the information systems area have three principal sources, **reuse** of software, **load leveling** for more efficient use, and **risk shifting** through portfolio management.

- **Reuse of Software** — A software system can be written once, and then sold many, many times. A piece of software that cost $100 million to write will cost a vendor only $100,000 per copy if the vendor makes 1,000 sales; a smaller vendor will find with only 100 sales will find that the same system cost $1 million per copy, and an independent user who developed the system for his own use will find his development for the same system cost $100 million for his single copy.
- **Load leveling and efficient utilization** — Employing an expert with enormous skill in a specialized area may be difficult to justify if he can be fully utilized in his area of specialization only a few months each year. A large supplier of skilled personnel may have several clients, each of whom needs this skill a few months each year, leading to nearly full use of this specialist.
- **Risk shifting** — A project with a great expected return on investment may still be too risky for a small firm to undertake in-house if there is a sufficiently large downside risk, no matter how low its probability. A large vendor, with many such projects under way at once is unlikely to have all high loss / low probability outcomes occur simultaneously, and thus is more able to absorb the risk associated with any one of the projects.

Economies of **scope** are more simple to describe. A firm that does a great deal of related work — customer profitability analysis in banking, telecommunications, and insurance, for example — will be faster to determine the requirements of a specific client. Moreover, scope leads to economies of scale, in that a vendor with an area of specialization may already possess systems that require only limited customization and tailoring before successful installation in a different but related business.

Similarly, economies of **specialization** can readily be described. A firm that does a great deal of work in any specific software area is likely to enjoy a higher degree of skill in its area of specialization, and a firm that does a great deal of contract software is likely to have specialists in all areas of project bidding and project management, and thus to do a better job in estimating cost and in managing development.

3.2. Value Creation

Economies of scale and scope can create value as well as reduce costs. A principal source of this value creation is the enhanced ability of an expert to determine requirements and to produce higher quality deliverables, based upon shared expertise, greater experience, or more thorough testing. Likewise, economies of specialization can create value as well as reduce costs. Again, this is based principally upon the enhanced ability of an expert to determine requirements, as a result of shared expertise based on greater experience.

Outsourcing can provide economic benefits through faster completion of development projects. It is frequently much faster to acquire systems from developers who already have completed products available for installation than it would be to develop the same systems *de novo*, even if the vendor's system will require customization and tailoring. This speed of acquisition can create significant economic value for the client as the purchaser of third party systems. If the client wants to bring a new product to market rapidly, and if these systems are in some way key to the product's development, then this form of outsourcing may significantly reduce the buyer's time to bring his product to market. This may allow the client to capture first mover advantages if the client is the innovator, or may reduce the first mover advantages of competitors if the client is attempting to catch up before competitors have captured the market.

4. Costs and Risks of Contracting

Given the benefits we have seen that may be available from outsourcing, what limits the use of outsourcing? That is, why don't firms purchase more software, outsource more development, and outsource more facilities management services? Why do most firms maintain extensive internal systems capability and why don't they outsource everything in the information systems area?

The most obvious answer is that outsourcing increases costs and risks, in three ways.

- It creates **transactions costs**. Transactions costs are the costs, not of producing or purchasing something, but of arranging to produce it or purchase it. These are **frictional** or **coordination** costs. It may cost more to administer contract employees, or to deal with additional layers of staffing both within the client firm and within the vendor firm, and ultimately these costs will be passed on to the buyer. Likewise, it may cost more to develop a specification for an outside contract then it would cost to develop a specification for internal development.
- It creates **contractual risks**. That is, there may be a greater risk of deliberate contractual abuse, for profit, by an outside contractor than there would be from an internal development team.
- It creates **risk-based costs**. By creating contractual risk, it creates the need to invest in managing these risks.

Contract risks are principally of one of the following three types:

- **Shirking**
- **Poaching**
- **Opportunistic Repricing** or **Holdup**

Shirking may appear as deliberate underperformance, while claiming full payment, if the vendor believes that he can do this without detection. That may mean billing for more hours than were worked. It may involve bait-and-switch staffing, providing excellent staffers at first and then replacing them with less qualified personnel. These employees are at the same level and the same billing rate, but are less productive and do inferior work. Alternatively, it may mean failure to employ best practices, delivering code that is not fully tested, or not fully documented, or extremely difficult to maintain, while charging for a fully completed job done to best practices and to best industry standards.

Poaching represents the loss of control over an information asset. A vendor may develop a strategy, and a strategic application for one client, who is willing to pay the high development cost because of the competitive advantage that is expected to result. Then vendor can then take the expertise gained with the first client and redevelop the system for a second client. The second client's cost is likely to be lower, placing the first client at a disadvantage rather than offering the first client a sustainable advantage. (Equally damaging, but more easily detected, the vendor may decide to use the expertise directly, entering business as a competitor.)

Holdup occurs when the vendor is able to unilaterally increase prices. When a client enters into a long-term contract it is not uncommon for the vendor to change the terms at some point, perhaps during a later year of the contract, perhaps at a renewal point. This change often involved increasing pricing, and is usually seen by the client as some form of overcharging; it can take the form of the vendor's unanticipated overcharging for later years of the contract, or as the vendor's unanticipated overcharging for enhancements and extensions that were not explicitly described in the initial contract. Frequently, the client has significantly reduced his internal capabilities, to the point where he cannot readily reassume responsibility for the activities that have been outsourced. Moreover, it is virtually impossible to find a third party ready to step in immediately and accept responsibility for critical systems operations. Thus, even if the repricing is seen as abusive, the client often has no alternative but to accept the revised terms. In the information systems area this is frequently called "vendor holdup."

Contractual risks are generally seen as important because they create costs, which limit the value of the contract:

- **Contracting** — Contracting is made more expensive, as more detailed specifications are demanded, more elaborate checkpoints and milestones are created, and more negotiations between the actual buyer and seller, and between the legal staffs of the buyer and seller, are required.
- **Monitoring** — The fear of shirking, in particular, results in elaborate systems for monitoring contract performance. This can include redundant testing, on-site observers, and other expenses.
- **Expected losses** — It is expected that some contractual abuse will go undetected. Others, even if detected, will be difficult to prove, and thus will not be subject to contrac-

tual remedies. In either case, losses will be unrecoverable. This leads client, vendor, or both to anticipate some economic loss as a result of an outsourcing relationship.

From our perspective, contractual risks are important principally because these risks increase fear and thus reduce the stability of otherwise mutually beneficial commercial relationships. That is, we study the economics of contract risk because it provides the primary implicit driver for the psychological stress and the behavioral patterns that significantly damage so many strategic partnerships, alliances, and sourcing arrangements.

5. The Central Dilemma and the Need for Renegotiation

The central dilemma of outsourcing information services is the need to reconcile three incompatible requirements. To be meaningful, a contract for information services must be **long term**, must be **unambiguous**, and must **bind the behavior** of both parties. However, as we shall demonstrate, IT outsourcing contracts generally cannot satisfy all three. This is the source of much anxiety and the cause of most outsourcing failures. It is also the reason that managing strategic sourcing requires managerial judgment and insight, and the reason that it is increasingly the responsibility of senior management.

Unfortunately, outsourcing information services has a high degree of strategic uncertainty, driven by the rapid change of systems technology and by the rapid change of requirements associated with today’s highly fluid business environment:

- Previously stable sales and marketing departments have been disrupted by eCommerce, net-based marketing, online eCommerce through existing channels, online eCommerce with new partners, and the prospect of still more sets of distribution channels. The terms of the development contracts require the vendor to deliver, and the client to pay for, applications that no longer fit the client’s current competitive environment or current business strategy.
- Outsourcing arrangements that were priced assuming a high volume of requests through central data processing facilities turn out to be mispriced when much of the transaction volume migrates to local processing under newer client server architectures. The terms of the contract require the vendor to maintain, and the client to pay for, far larger central facilities than will ever be used.
- Help desks for main frame services quickly were replaced with help desks for desk top computing, which are evolving into requirements for networked systems. The terms of the contract obligate the vendor to deliver, and the client to pay for, services that are no longer required.

As each of these examples illustrates, outsourcing contracts for information services suffers from a high degree of uncertainty concerning future needs. Thus, outsourcing information services is different from outsourcing canteen services at a hospital or university, where dietary patterns and preferences change only slowly and are largely predictable.

In the presence of a high degree of strategic uncertainty a contract cannot be long term, unambiguous, and binding at the same time and still preserve the possibility of adapting to a changed competitive environment. That is, if the contract, when drafted, had been long term, complete and unambiguous, and binding, then it would prevent accommodating new requirements or exploiting new business opportunities that were unanticipated when the contract was drafted. If the contract, when drafted, had been complete and unambiguous then changes to the specified actions, or changes to the cost and price structures, will be required to take advantage of these changed conditions.

Which term of our definition are we willing to sacrifice? Will we accept that the contract can deliberately be made ambiguous or incomplete? Will we allow the contract to be short term, subject to constant renegotiation, renewal, or termination without penalty? Or will we allow the contract to be indicative and non-binding, with either party, or both parties, able to change the terms at will? Usually, we are prepared to drop none of the terms of our definition of a contract, which means that post-contractual renegotiation and change will be required. That is, the central dilemma — incompatibility of our three contractual requirements — inevitably leads either to dissatisfaction or to contract renegotiations.

6. Contract Renegotiation in an Environment of Uncertainty

Contractual renegotiations will occur in an environment of uncertainty:

- Uncertainty about what the true **requirements** will be going forward
- Uncertainty about the **actions** of different players, based on lack of complete and verifiable observations
- Uncertainty about **objectives** of each party, in the presence of incentives that can never be totally or perfectly aligned (the sad fact is that the more the vendor gets, the less the client keeps)

There will even be uncertainty about whose objectives any individual will be pursuing at any time. Contract officers on either side sometimes have their own agendas. Making your own individual sales quota should never be more important than negotiation of a contract that your firm can deliver successfully. Selling a contract that years later will be seen to be below cost, just to close a deal in time for you to make partner, will never be good for your firm. Neither would ever occur if individuals always acted as agents of their firms rather than as individuals with their own incentives and requirements.

Because of these uncertainties, any revision of the contract will occur in an environment characterized by **distrust** of the other party, based on knowledge of contractual risks and fear of contractual abuse during contract revisions. This distrust is understood to some extent, as it based on forms of uncertainty that are widely acknowledged. However, contractual revision also occurs in an environment plagued by **uncertainty of perception**, based on perceptions of events that are not fully aligned. Each side sees only part of each interaction, and sees it in an environment already colored by distrust. Most of us are unaware that these differences in perception occur, and indeed occur constantly.

The explanation for this is simple:

- Human beings, when faced with ambiguity, make **simplifying assumptions** and fit the behavior of their colleagues, clients, vendors, and opponents into straightforward, stereotypical categories.
- Human beings, when faced with ambiguity in the presence of risk, uncertainty, and stress, will frequently make **worst case assumptions** (*"I don't know what you're doing but I'm sure it's not good. You want to change the requirements; you probably are going to cut corners and save money for yourself."*)
- Once these assumptions are made and once events are placed into their categories, the categorization takes on **authority and legitimacy**. That is, we do not remember that we made assumptions and simplification, we remember our categorizations as complete, accurate, and absolute.

The patterns adopted by each side to explain events will be different, as each side is subject to different risks and as a result has different fears, and as each side uses different worst case simplifications. The adoption of these different patterns will result in divergence of perceptions of ongoing events. As the perceptions of events diverge, the behavior of the other side becomes easier to see as abusive; this provokes responses that, rather than helping restore the relationship to a productive state, are seen as abusive in return. That is, once a contract or a relationship gets out of alignment, natural processes tend to exacerbate differences in perception and increase misalignment of historical perspectives. Contractual trust is thus unstable, and as each side prepares to defend itself against unintended abuse, and as each side is seen as abusive in turn, value-creating relationships become more fragile and value-creating contracts become unmanageable.

7. The Role of Mis-Aligned Historical Perspectives

'Roshomon," by Ryunosuke Akutagawa, provides a modern classic on the impossibility of verifying perceptions, or of ever truly understanding events as seen by others.[2] The story initially appears quite simple: A samurai warrior and his lady are walking through a bamboo grove. A highwayman appears and, within minutes, the samurai is dead and his lady has become physically intimate with the highwayman. They are apprehended by a woodcutter and taken before a magistrate on charges of murder. The ghost of the dead samurai, the lady, the highwayman, and the woodcutter all provide testimony. The ghost of the samurai claims that he was overcome after a savage struggle and his lady resisted the highwayman, defending his honor and her own. The highwayman assures the magistrate that he could never have overcome a samurai without assistance, and that the lady was his willing accomplice. The remaining accounts only add to the ambiguity:

- Was it a rape? A seduction? A premeditated betrayal?
- Was it a murder? Self-defense? Suicide?

The magistrate, the reader, even the principals in the story — none will ever know the answer to any of these questions with certainty. Most of us have no tolerance for this degree of ambiguity outside the narrowly defined contexts of a novel or a movie theater! Instead, when faced with highly stressful and highly ambiguous situations, such as contract revisions, we do the following:

- **We find a pattern** that seems to explain most of what happened, give the event a name ("the great betrayal of the Y2K agreement"), stick our recollection of the event it in its pigeon-hole ("vendor betrayal"), and respond as the pigeon-holing would demand.
- No event ever fits completely or perfectly within a pigeon-hole, but once we have found one that seems to work **we ignore evidence inconsistent with the selected pattern**.
- When we have selected the wrong pattern, this pattern causes us to **misinterpret future events and thus to act inappropriately**. That is, worse than ignoring *initial* contradictory or disconfirming evidence when first selecting a pattern to explain events, once a pattern has been selected we no longer even perceive disconfirming evidence *as new events unfold*. We cannot accurately see what is now happening, and we cannot take appropriate actions to restore trust or the stability of the value-adding relationships.
- When we and our counter-parties have selected different pigeon-holes and are using different patterns to explain the same events, we literally **cannot speak to each other about these events as they occur**. After the filtering that comes when events are seen through our pigeon holes, we are not experiencing the same events, we do not remember the same

[2] Akutagawa, R., **Roshomon and Other Stories**, (tr. T. Kojima), Charles E. Tuttle Co. 1984.

details as significant, and we can barely understand each other when we describe recent history.

- Naturally, since actions are taken in response to events that we alone have experienced, and that our counterparties have not, we **cannot interpret, let alone tolerate, each others' actions**!

To review, we began with a treatment of the economics of risks associated with sourcing, because it is these risks, and the associated fear of economic abuse, that sets the tone of mistrust as soon as contract terms need to be revised. We now discuss the most common and most damaging behaviors that result from this mistrust. However, it is important to note that in each case, both of the parties believe that they are acting in good faith and that they are acting in an acceptable manner. This misplaced confidence in the correctness of one's owns actions, even as they are destroying a valuable relationship, is generated by the inaccurate perception of the other side's intentions and the flawed interpretation of the other side's actions as economically exploitive. Once again, although the problems are behavioral, resulting from perceptions and psychology, they are ultimately driven by the economic analysis of risk that is performed, at least implicitly, by both sides.

The following short list of categories describes many of the pigeon-holes we use when our contractual partners take actions that we fail to understand. Each is a universal human pattern, ingrained since childhood. Each carries the same moral certainty, the same sense of outrage, and the same general emotive content that it had when we first experienced it at home, in the classroom, or, more likely, in a fight during recess:

7.1. *But I ate mine / Give me yours*

The vendor of a large outsourcing contract discovers, several years into the contract, that he has been miscalculating his costs for delivering the services that the client has been demanding, and that consequently he has been mispricing his services for operating the client's data center. For years he has been charging too little. While he agrees not to attempt to recover foregone profits that were caused by this pricing error, the vendor does immediately reprice the contract to reflect the client's current demand and his own costs for meeting this demand. The client, however, has not budgeted for this increase, has no uncommitted funding to cover this increase, and does not want to pay the higher prices; instead, the client says that since he has no budget left, and since it is the vendor's fault, the vendor should absorb another year of losses as part of the natural give-and-take of any contractual relationship. With no history of such reciprocity, and no history of the client making financial concessions to the vendor, the vendor hears the client's request as a simple demand: *"I ate mine. Give me yours."* The demand is refused, the client is astounded, and working relationships rapidly deteriorate.

How do you avoid this problem? First, and foremost, you avoid a unilateral demand: you don't ask for anything without giving something back. Second, be aware of what you are doing. In this case the vendor is as embarrassed as the client, and has taken sustained and unexpected losses; the client should probably be aware of the fact she has no budget does not, in the vendor's mind, justify asking him to take more losses.

7.2. *Give me more / I need another one / I'll let you know when it's enough*

As a response to a client's concerns that one area of a full service contract was overpriced, the vendor agreed to a series of concessions over the course of six months, such as delayed implementation of scheduled contract price increases and free Y2K maintenance on programs that were scheduled to be rewritten in subsequent years. The vendor saw much of the effort that would be needed to provide this free Y2K maintenance as essential to understanding the client's current systems environment, and thus believed that much of the effort could be justified as an essential investment in preparation for implementing the new applications. The client saw these concessions as proof that the initial contract had been over-priced and demanded additional concessions. Ultimately, the client decided that he had the right to cancel new applications development, while having the Y2K maintenance on existing applications done without charge, as "agreed." If the vendor accepts this change, then the free Y2K maintenance does indeed become free, rather than an investment that will be useful during later work. While the client sees the vendor's concessions as proof of prior abuse, the vendor now sees the client's never-ending sequence of demands as an indication that this client was not interested in creating a long term relationship, but merely in taking as much as it could, as fast as it could, for as long as it could. The vendor now hears *"Give me more. Give me another one. I'll let you know when it's enough."* The latest demands are refused, the client is astounded, and working relationships rapidly deteriorate.

How do you avoid this problem? Once again, you start by avoiding a unilateral demand: you don't ask for anything without giving something back. Second, be aware of what you are doing. Once you have gotten something, in this case the free Y2K consulting, it will be seen as extremely abusive if you take back the promised new applications development.

7.3. *But my piece is smaller than I expected / Give me yours*

The client in a call center outsourcing contract agreed to a fixed price for operation of inbound (accepting calls) and outbound (making calls) sales support. The client will pay for the vendor's services, and the upside value creation — revenues from sales — was to be retained by the client. Unfortunately, the client's competitors all undertook similar sales campaigns, and the anticipated increase in sales, revenues, and profits, did not materialize. The client demanded a price reduction to compensate for the unexpectedly low payoff from the sales campaign, despite the fact that the vendor's investment in training and support systems, staffing levels, and staffing quality were as promised, and that the vendor had incurred the full anticipated cost of the contract. The vendor knew that the client would not have shared profits that resulted if the contract had produced the expected results, nor would the client have shared any extraordinary profits if the contract had produced better results than expected. Therefore, while the client is demanding that they share the pain, the vendor hears only *"But my piece is smaller than I expected / Give me yours!"* The contract is terminated and neither party works with the other again.

How do you avoid this problem? Once again, you start by avoiding a unilateral demand: you don't ask for anything without giving something back. Second, be aware of what you are doing. If you are demanding money back from a vendor who has performed as you requested, and if your reason for doing so is unforeseen events that were outside the vendor's control, you may be seen as untrustworthy. If you are doing so in an environment in which, were the circumstances reversed you would be outraged to have the vendor request money from you, you can be certain assured that you well be seen as untrustworthy.

7.4. *But your piece is bigger than I expected / Give me yours*

In a full service outsourcing contract each of the strategic business units is delighted with the quality of work done by the vendor, by the speed of the vendor's response, and by the price charged for work completed. Increasingly, the CIOs of individual strategic business units begin to negotiate additional contracts, specifying many of them as high priority, with expedited delivery and premium pricing as a result. While the CIOs and the management teams at the individual business units were delighted with the work that they received from the vendor, the client's corporate CFO was appalled, since the vendor's billings were a significant multiple of the original contract amount. The vendor had received nothing but praise for speed, responsiveness, quality of work done, and the prices for which the work had been completed. Now the CFO starts saying that the vendor is getting paid too much, needs to give some money back, and cannot be trusted to negotiate deals with the business units that need and that are paying for the work. While the CFO is merely trying to regain some control over expenses, the vendor hears *"But your piece is bigger than I expected / Give me yours!"* The vendor's response nearly terminates the contract, and thus nearly ends a relationship that has been profitable for the vendor, and has enabled the client to exploit extremely profitable opportunities in its marketplace around the world.

How do you avoid this problem? This time, you need to start by attempting to understand what you are doing. That is, first determine why you want something back. What, exactly, is the problem here? Failure to receive value for payment made? Failure to control subsidiaries and the subordinates who control them? Or just payments higher than you expected? Second, you decide why you think that you are entitled to get something back, given the quality of service that you have received. Finally, if you decide you have a convincing argument for a rebate, such as discounts based on scale, you once again remember to avoid a unilateral demand: you don't ask for anything without giving something back. You may be able to negotiate retroactive rebates in exchange for assuring that the larger, and successful, consulting relationships continue. If you demand a rebate, simply because the vendor delivered what was demanded by the subsidiaries, you surely run the risk of destroying a strategic, important, value-adding relationship.

7.5. *I didn't understand / You lied to me and I'm gonna get even*

Two travel agencies, in two different countries, formed a strategic alliance. Each felt that their very demanding clients would require better service in their partner's home country than they themselves were able to deliver "by remote control," and each felt that the other would be able to provide the high degree of service that they required for these clients. Both believed that since each already delivered a high degree of service for their most demanding clients, each would be able to satisfy the other's needs. More importantly, each believed that the expenses that they would incur in serving their partner's clients in their market would be roughly the same as their partner's expenditures in serving their clients in the partner's market.

Two problems were encountered immediately, although neither was recognized at the time:

- The U.K. company's demanding clients were stars and celebrities in film, theater, and pop music. Their requirements were for last-minute change of schedule as plays opened and closed at times other than anticipated, for locking in "their" suites at top New York and LA hotels for months at a time with little or no advance notice, and for arranging for their furniture to follow them from hotel to hotel as rapidly as they changed cities themselves. The U.S. company's demanding clients were middle level and senior executives who wanted free upgrades from business class to first class on transatlantic flights. Neither company was prepared to deliver the kind of service that the other needed, and both felt that the other had misrepresented what was required.
- The services provided by each company tended to be rebookings, often under extreme conditions, rather than new bookings. These are difficult, require making personal demands upon suppliers, and thus in a real sense, they are expensive to provide. However, by definition, unlike new bookings such rebooking services do not produce revenue for the agent making the changes. Worse, such services are visible to the party doing the work, but not to the party whose client's receive the benefits. Thus, each party knew how hard it was working for the partner's clients, without compensation, but had no idea how hard its partner was working for its clients when they were abroad, again without compensation. Thus, both parties were aware of their own expenditures as a result of the strategic alliance, and believed that their counter-parties were not incurring similar expenses; once again, both parties felt that the other party had misrepresented the reciprocal nature of the service agreement.

These misperceptions and failures of communication were never fully surfaced and were never fully understood. Each party felt justified in taking actions that were both self-protective and punitive. Each party heard the other saying *"I didn't understand / You lied to me and I'm gonna get even*!" The alliance, which was begun with such high hopes, has been terminated.

How do you avoid this problem? You avoid assuming that a misunderstanding is the result of intentional misrepresentation. Just as important, you avoid assuming that you have complete information. Although the information available to you suggests to you that you are being abused, you cannot conclude that you are indeed being abused. Indeed, the information available to your counter-party may be just as convincing, and he may be just as dissatisfied, based on the equally incomplete information available to him.

7.6. *You've been bad / I'm telling / Boy, are you gonna be sorry!*

The CIO of a client organization negotiated a wide-ranging outsourcing contract, under terms that now appear surprisingly generous to the vendor, after which the CIO unexpectedly resigned and took a position with the vendor. The incoming CIO took a look at the deal, did some bench-marking, and decided that it was a sweetheart deal that was over-priced by about 20% compared to norms for the industry. The new CIO also expressed concern about whether or not the overly generous terms granted the vendor represented an explicit conflict of interest between the previous CIO's obligations to the client firm and his obtaining new employment with the vendor. That is, was the position with the vendor a direct payment for his agreeing, while still serving as CIO at his old firm, to sign a contract that overcharged the firm? Almost as soon as he took office, the client's new CIO demanded that the contract be renegotiated.

At the same time the vendor introduced a new relationship manager, who was immediately blind-sided by the new CIO and his demands. At the first of the regularly scheduled quarterly meeting with the client's Chairman, the vendor's relationship manager described the demands of the client's new CIO and asked for advice on how to deal with the difficult contract renegotiations. The vendor did not want the recent changes in personnel and the deep concerns of the new CIO to lead to personal animosity, which would interfere with the performance of the contract.

The relationship manager believed that he was sharing important information, in a collaborative manner, to avert later difficulties in the contract. The CIO was certain that the vendor relationship manager had gone directly to the Chairman to complain; that is, the CIO hears the vendor saying to him, or about him, *"You've been bad / I'm telling / Boy, are you gonna be sorry!"* The CIO promptly goes to the Chairman to complain about the vendor, and the vendor now hears the CIO saying to him, or about him, *"You've been bad / I'm telling / Boy, are you gonna be sorry!"* The new CIO is contemplating a law suit for damaging his relationship with his employer. This contract is still having difficulty getting back on track.

How do you avoid this problem? You avoid assuming that a meeting is being held without you, or a communications channel is being opened, solely to sabotage you. Although the information available to client suggested that the client CIO was being attacked by the vendor relationship manager, this was, in fact, not the case. When the information available to the vendor led him to decide that he was being attacked by the client, an environment of extreme distrust was created, which has been difficult to correct.

7.7. *You've hurt my feelings / I'm not going to play with you any more!*

Two organizations, in order to speed their entry into eCommerce, agree to work together for their initial offerings. One individual, senior at the "design" firm, arrives to present a design prepared after lengthy consultations with a single colleague from the "development" firm. As an act of good faith, he presents the design as complete and as an offering to his colleagues at the development firm. Colleagues at the development firm are outraged that this design has been prepared without consultation with any of them, and refuse to discuss it further. They say, loudly and clearly, *"You've hurt my feelings / I'm not going to play with you any more!"* The designer leaves, not sure what to do after his good faith offering has been rejected, and his colleagues interpret this to be his saying *"You've hurt my feelings / I'm not going to play with you any more!"* For the moment, neither organization appears to know how to get the joint development effort back on track.

How do you avoid this problem? You avoid assuming that a perceived slight or insult is the result of intentional disrespect. The presenter thought that offering a completed initial design was helpful and efficient, not a sign of disrespect. Just as important, you avoid assuming that you have complete information. Although the information available to the audience suggests that the presenter believed that he knew far more than they, what the audience did not know is that the presenter was brought in to give his initial design; in order to avoid offending his own designers, the officer calling the meeting did not inform the audience that the meeting had been called to review a completed design, and not to begin initial design discussions. Finally, the entire problem might have been avoided if the initial intent of the meeting had been clearly and symmetrically communicated to both sides.

8. Regaining Control by Realigning the Perception of Shared History

Unfortunately, problems are frequently not detected in time to be avoided, as we described above, or in time to keep them from cascading. That is, the misperceptions described above often come in pairs or sequences:

- One party sees what looks like *"But I ate mine; give me yours!"* and reacts in anger.
- The other party sees the angry reaction as *"I'm telling; I'm gonna get you punished!"* and becomes just as angry.
- Both parties are now enraged, discussions are based on divergent perceptions of critical events and therefore will be unproductive, or may even make the situation worse
- And soon we're headed towards litigation

Situations like this frequently result in what we call our ***911 Service*** calls; calls from clients for immediate intervention to respond to a crisis and keep it from deteriorating into more complex and more expensive emergency.

Fortunately, early intervention can frequently permit full recovery.

Our experience is that while the seven categories of misperceptions described above and the means to avoid each are different, the intervention for the problems created by them, singly and in sequence, is largely the same. The objective is to get both parties' perceptions of history back in alignment. The first step is to figure out, if not what actually happened, at least what each side believes actually happened. After that it becomes possible, and often sufficient, to convince both sides that there are indeed at least two legitimate and very different perceptions of events. Thus it is often possible to reconstruct an environment in which meaningful dialog is possible, after which the logic of economic gain is often sufficient to reconstruct a meaningful contract and a meaningful relationship. Of course, it is critical for both sides to remember that their relationship will encounter additional moments of stress and ambiguity, and that their perceptions of shared history will almost certainly get out of alignment once again. That is, first we fix the contract, then we remind both parties that they will need to be vigilant in the preservation of their working relationship, in order to avoid reoccurrence of precisely the problems that brought us all together in the first place.

One of the most striking and powerful intervention techniques we have employed explicitly acknowledges the lesson of Roshomon: human perception of an event will be strongly colored by desires, fears, passions, and chance. Different parties are most unlikely ever to see the same sequence of important events in the same way.

- Our intervention begins by **convincing both parties that we can see their point of view**: it is most important, before attempting to change someone's perception, first to demonstrate convincingly that you can see events from their perspective. We do this by researching their perception of events and then by summarizing, carefully and thoroughly, the sequence events precisely as they would describe them. We do this for both parties to the dispute, and we do this for both parties separately of course.
- Next we to return to both parties, if not as an ally then as a credible, trusted, and fair observer and recorder of events, and **show how the same events look so very different to the other side**. Once again, we do this for both parties to the dispute, and we do it for both parties separately. This is intervention is surprisingly powerful: each side can now see the other as more than irrational or dishonorable; each can see the other as, in its own view, potentially aggrieved. Once each can acknowledge that the other has, if not a legitimate grievance, than at least a legitimate point of view, discussion can once again resume.

The most powerful technique we have developed for beginning the process of realigning perceptions of history, and the most striking, is to use the same set of presentation materials four times, telling a very different story each of the four times. The first two uses are to communicate to the client and vendor that we fully understand **their** perception of events and that we firmly believe that they have a legitimate position. The second two uses are to come back, as a trusted observer, and show how the same events looked to the other side.

- **First use, with <u>client</u>:** *"Yep, that's what happened. You understand us. We're gonna make sure those contractors never get another job in this industry. We'll sue the bastards too!"*
- **Second use, with <u>vendor</u>:** *"Yep, that's what happened. She doesn't know who she's dealing with. We'll get her boss to kill her. She'll never work again in this industry!"*
- **Third use, back with <u>client</u>:** *"Oh, my lord. Of course it looked that way to them. We're lucky they didn't just walk away from our data center and let us die. We have no basis for a law suit."*
- **Fourth Use, back with <u>vendor</u>:** *"Oh my lord. Of course it looked that way to her. We're lucky she didn't take us to court yet. How can we ever explain this to her?"*

It is now possible to reopen value-creating negotiations.

9. Guidelines

Information services contracts need to be managed over time and vendor relationships need to be managed over time, specifically to produce greater value. In the information services area, managing contracts and relationships to maximize value creation over time will be consistently and uniformly better than managing costs in a sequence of contracts to low cost bidders. It will likewise be consistently and uniformly better than managing costs through a sequence of attempts to demand concessions from vendors.

We have attempted to establish the following guidelines for vendor management:

- All contracts in information services will require a higher degree of adaptation and change than similar contracts in other areas, requiring greater skill in vendor management.
- The contract is only a starting point. You can change anything.
- Any change to the contract needs to be negotiated, and needs to be negotiated in an environment where requested change will be seen as potentially exploitive or abusive.

Any contract can be changed, but the negotiated change must make both parties better off than continuing to enforce the terms of the current contract.

- Events will almost always be seen differently by different parties. Change will often appear to be exploitive and opportunistic. Renegotiation will need to be done carefully.
- Never attribute to malevolence what can be explained through misunderstanding or incompetence. Never assume that your counterparty has exploitive intent without verification. That is, before engaging lawyers, shooting off defensive memos within your organization, or launching an all-out counter-attack, it should be seen not only as useful but as essential to make an effort to find out what happened and why. In particular, it is useful to know not only what the other side thought it was doing, but why it thought it was entitled to act the way it did.
- Trust is fragile. When changing the contract it is necessary to give something in order to get something.
- Be explicit about what you require. Never ask the other side to play *"I need another one."* Never play *"I need another one"* yourself.
- Remember that a good contract does not assure your optimal outcome. If you have off-loaded your risk to the vendor by negotiating a fixed price contract, you will safely avoid cost increases. However, if costs go down more than expected you may find that the vendor is enjoying unexpectedly high profits. This does not represent contractual abuse or exploitation by the vendor and does not signify that you have written or accepted a bad contract. Likewise, you may not be entitled to share in these gains, any more than the vendor would be entitled to pass cost increases through to you beyond those specified in the contract. That said, it may indeed be appropriate to renegotiate and to request some of the gains; it is, however, necessary to be prepared to offer give something while requesting something. For example, if the contract is more profitable than the vendor anticipated, the vendor may indeed agree to a rebate in return for a contract extension.
- It is necessary to manage your own contract officers and to understand ways in which their training, abilities, and incentives may differ from those of your organization.

Finally, and most importantly, manage the contract for maximum benefits. Remember that *"the concrete and the measurable often drives out the significant."* That is, demanding small concessions and rebates frequently takes on greater importance than effective contract management, especially when the concessions and rebates can be directly attributed to the contract officer. It is a danger in all information services contracting. Destroying trust destroys the prospect of value-enhancing adaption to contractual relationships. Conversely, and more beneficial, maintaining trust produces considerable economic gain, and the return on trust produces more than enough gain to satisfy both parties. That is, proper attention from and proper motivation from the senior management team during negotiations and at contract initiation can frequently avert the need for ***911 Service*** calls at a later time.

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