

Negotiating the Spirit of the Deal

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You know how
to hammer out
the terms of
an economic
contract – but what
about the social
contract?

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EXPERIENCED NEGOTIATORS are generally comfortable working out the terms of an economic contract: They bargain for the best price, haggle over equity splits, and iron out detailed exit clauses. But these same seasoned professionals often spend so much time hammering out the letter of the deal that they pay little attention to the social contract, or the spirit of the deal. So while the parties agree to the same terms on paper, they may actually have very different expectations about how the agreement will work in practice. Without their arriving at a true meeting of the minds, the deal they've signed may sour.

Consider the fate of a joint venture launched by two chains: a national hospital organization and a regional health care provider. Executives at these organizations realized that two of their hospitals, located near each

other, were competing for doctors' practices and building redundant facilities. In response, they enthusiastically negotiated a joint venture that would manage the two hospitals and buy or build needed facilities within their shared area.

The two partners created a governance system and appointed managers to whom they offered incentives to maximize the venture's profits. Yet despite compelling economics, the arrangement didn't last – largely because the partners held clashing but unspoken assumptions about the joint venture's purpose. Moreover, the contract they actually negotiated didn't fit either organization's real objective.

Because the national chain had only one hospital in the region, it resisted economically sensible steps, like eliminating redundant departments, which were consistent

with the joint venture's formal contract and management incentives. The national chain was understandably concerned that the joint venture might one day fail and its hospital—now offering reduced services—would no longer be competitive. Executives at the regional chain, by contrast, saw the joint venture as a way to extend and rationalize their regional network. They persisted in trying to make the regional operation more efficient, but the formal contract and management incentives—to maximize only the joint venture's profits—conflicted with that mission, too. Had the parties better understood each other's views of the underlying purpose of the venture in the first place, they might have forged a more limited, but more effective, agreement. Such a deal would have ignored possible operating efficiencies and focused on gains from jointly buying practices and building shared feeder facilities. As it happened, each organization's underlying expectations clashed both with the other's and with the actual contract, transforming enthusiasm and potential profits into a swamp of recriminations.

Based on our participation in hundreds of negotiations and a growing body of academic work on implicit and "relational" contracts, we have come to believe that cultivating a shared understanding of the spirit of the deal can be every bit as important as agreeing on the letter of the deal.¹ This article explains what the social contract is, shows how the parties' views of the social contract can sharply diverge, explores problems that arise when the social and economic contracts are at odds, and suggests ways to negotiate both so that they are independently strong as well as mutually reinforcing.

The Underlying Social Contract

The term "social contract" carries political connotations, bringing to mind the writings of Locke and Rousseau, but we use the concept on a radically smaller scale. In a negotiation context, we define the social contract in terms of the parties' expectations. This contract has two levels: The *underlying social contract* answers the question, What? (For instance, are we working out a series of discrete transactions or a real partnership? *What* is the real nature, extent, and duration of our agreement?) The *ongoing social contract* answers the question, How? (In practice, *how* will we make decisions, handle unforeseen events, communicate, and resolve disputes?)

We'll look at the underlying social contract first. Too many negotiators leave the underlying social contract implicit, which can cause misunderstandings and ultimately poison a relationship. Rather than discuss their expectations during negotiations, the parties project their own reasonable, but sometimes incompatible, assumptions about the fundamental nature of the deal. Some people, for instance, view a contract as a starting point for a problem-solving relationship. Dan Orum, the president

of Online Operations at Oxygen Media, is in that camp. He says, "The five words I most hate to hear in my business dealings [are], 'It's not in the contract.'" If the person he is negotiating with takes a more legalistic approach and sees the contract as an exhaustive description of mutual obligations, issues are bound to arise. That's why parties should strive for a real meeting of the minds on whether they are entering a problem-solving partnership or simply making a series of discrete transactions. Each approach is valid; the important thing is to recognize the potential for differing views and to try to align them.

Like clashing views of partnership versus transaction, divergent assumptions about autonomy versus conformity may create problems when the difference is identified late in the game. Consider what happened to an entrepreneur who failed to get clarity on this issue before she sold her boutique enterprise to a very eager corporate buyer. She decided to sell and agreed to stay on for five years because the purchaser assured her that she was "the essential player to lead the business to the next level" and because she envisioned her still-autonomous unit turbocharged by the acquirer's size, reach, and resources. The responsible corporate executive passionately shared her goal of taking the boutique concept global, but he simply assumed that only by following highly disciplined corporate procedures would the global rollout be possible.

Soon after the celebratory dinner, the unhappy reality began to dawn on the seller in the form of a legion of junior staff from HR delivering policy manuals and patronizing lectures on who bought whom. Even though the provisions of the economic contract—the letter of the deal on financial terms, governance, and the like—were acceptable to her, there had clearly been no meeting of the minds on the underlying social contract. Chances are, this will be one more failed acquisition despite its strategic logic, the skills and good intentions of both sides, and an acceptable economic contract.

Failure to make the underlying social contract explicit is by no means limited to small companies like the boutique enterprise. Take, for example, the proposed megamerger between Deutsche Bank and Dresdner, which would have produced the third-largest bank in the world

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(with \$1.25 trillion in assets), leading many people to view the planned deal as a landmark in the transformation of Europe's financial services industry. The banks planned to merge their retail operations, enabling them to close about 700 branches and concentrate on their more profitable corporate businesses.

Throughout the negotiations, Deutsche chairman Rolf Breuer implied that this was to be a "merger of equals." Although the new bank was to bear Deutsche Bank's name, the corporate color was to be Dresdner's green. Bernhard Walter, Dresdner's chairman, was particularly concerned that Deutsche would sell off Dresdner Kleinwort Benson (DrKB), which had contributed more than half of Dresdner's 1999 pretax profits. Aware of Dresdner's sensitivities, Breuer uttered words that would soon haunt him: "[DrKB] is a jewel, and we want to keep that jewel. It will be neither closed nor sold, and any reports to the contrary are 'barer Unsinn' [pure nonsense]." Satisfied, Walter declared, "A merger means you combine both parts into a new whole. I never had the slightest feeling that things would go differently."

Yet within hours of the joint announcement of the merger, Deutsche apparently decided to sell DrKB, believing that its own investment-banking arm had further global reach. And by selling the unit, Breuer wouldn't have to go through the long and expensive process of integrating DrKB's 7,500 employees. When DrKB staff members learned of this decision (from a *Financial Times* article by a source who came to be called the "torchman"), they moved to a state of alert.² The report mobilized powerful internal opponents to block the deal. In light of this clash—together with growing investor doubts about the deal's business rationale and actual terms—the merger was called off, after a month of furious negotiations, protestations of misunderstanding, and efforts at compromise. During that time, Deutsche's share price plunged 19%, and Dresdner's fell almost as much. Whether by accident or design, Deutsche's vision of the underlying social contract was at odds with Dresdner's, and those opposing assumptions helped to doom the deal.

Parties that differ in basic ways are especially likely to hold divergent views of the underlying social contract. Such differences could involve the companies' size, organizational approach, and business focus: small versus large, entrepreneurial versus bureaucratic, centrally man-

aged versus decentralized, and finance driven versus operations centered. For example, serious postalliance ownership conflict between Northwest Airlines and KLM Royal Dutch Airlines was less due to a cultural clash than it was exacerbated by a disagreement over management focus and risk tolerance. Pieter Bouw, KLM's Dutch president, stressed airline operations and conservative financial management. Gary Wilson and Al Checchi were high-profile, risk-taking financiers who had acquired Northwest in a highly leveraged buyout. Even agreement on the terms of an economic contract could not resolve those fundamentally different approaches to running an airline.

The examples given thus far illustrate some of the issues that need to be aired about whether minds have truly met on the underlying social contract. Other questions include, Is this a short- or long-term deal? Is it open-ended or task specific? Will it be learning or production oriented? Do we believe in lifetime or at-will employment? In countless deals, the tangible terms may seem fine, but the two sides realize only when it's too late that the reality doesn't match their expectations.

Although agreeing on the underlying social contract is important, a degree of what diplomats call "constructive ambiguity" is sometimes appropriate. Imagine, for example, two companies that both want control in a proposed equity joint venture. If pressed to fully resolve the issue at the outset, they would probably walk away from the deal. Yet if they could agree to launch a pilot venture with shared control, even if each side still believes that it must have total control in the ultimate venture, the deal might build their confidence in their ability to work together—even without such control. Success in the pilot could change the way they approach the social contract in the larger deal. As the French saying goes, "There could be no treaties without conflicting mental reservations." The trick, of course, is to distinguish true confidence-building steps from the papering over of fatal differences.

The Ongoing Social Contract

Just as important as the underlying social contract is the ongoing social contract. It answers the question, How will we work together? Properly negotiated, it outlines the broad process expectations for how the parties will interact: norms for communication, consultation, and

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decision making; how unforeseen events will be handled; dispute resolution; conditions and means for renegotiation; and the like.

A positive ongoing social contract can foster efficient sharing of information; lower the costs of complex adaptation; permit rapid exploitation of unexpected opportunities without the parties having to write, monitor, and enforce complete contracts; and reduce transaction costs and even fears of exploitation. In fact, in a 1997 study of North American and Asian automakers and suppliers, then Wharton professor Jeffrey Dyer found that “General Motors procurement (transaction) costs were more than twice those of Chrysler’s and six times higher than Toyota’s. GM’s transaction costs are persistently higher... because suppliers view GM as a much less trustworthy organization.”

Clearly, a well-functioning ongoing social contract is beneficial, but too often, partners hold conflicting expectations. Imagine, for example, that a global manufacturer has a joint venture with a major local distributor. The relationship runs smoothly until the manufacturer approaches another distributor about selling a different product line. Since the economic contract governing their joint venture said nothing about the new line, the manufacturer may think it perfectly reasonable to use another distributor. But the first distributor may have expected to have been given the opportunity and may think that the manufacturer has acted in bad faith. Because their assumptions were never made clear, their relationship suffers, even though no actual breach of contract has occurred.

Because conscious efforts to shape the social contract can help stave off problems like this, we suggest that both sides conduct an audit of sorts. They should formally ask such straightforward questions as, How will we handle proprietary information? About what actions – inside and outside the bounds of the deal – will we inform each other? How do we properly launch a partnership? (For more on questions to ask in an audit, see the sidebar “Conducting an Audit: Sample Questions.”)

A final note on forging a productive ongoing social contract: It is often beneficial for senior executives to be involved in every stage of the deal. Ford and Mazda did an excellent job at this. In 1969, the automakers began a remarkable strategic partnership, initially driven by Ford’s

search for a low-cost production source and Mazda’s desire to break into the U.S. market. Serious disputes erupted because of U.S. – Japanese political tensions, efforts to protect proprietary technology, cultural differences, product design, and material selection. To deal with these problems, senior executives (three top managers from Ford and Mazda and six other operating heads) held a three-day summit every eight months. The first two days of these summits were devoted to strategy and operations, but the third typically functioned to repair or realign the social contract as needed.

Risk Factors

The most common causes of social contract problems are lack of awareness and benign neglect. The parties involved inevitably form expectations about how the deal will be carried out, whether they discuss them or not. Even if initially compatible, those expectations can si-

Conducting an Audit: Sample Questions

Discussing expectations *before* you sign a deal can greatly increase the odds of its success. To help you get that conversation started, here are some sample questions about the letter and spirit of your deal.

Underlying Social Contract

Real nature and purpose of the agreement

Do you envision a discrete transaction or a partnership? A merger of equals or something quite different? Are you building an institution for the long term or making a financial investment with a nearer horizon? What is the driving culture (operational, for example, or research oriented)?

Scope and duration

Is your agreement focused on a discrete, short-term task, or is it open-ended? Is it a likely prelude to a larger or different arrangement? What kinds of actions, even outside the bounds of the deal, do you expect to be told about? And about which do you expect some say?

