NEGOTIATING THE SPIRIT OF THE DEAL:
CRAFTING THE SOCIAL CONTRACT

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Most experienced negotiators are comfortable working out the terms of the “economic contract,” or the “letter of the deal” around issues such as price, investment, equity splits, governance provisions, warranties, and exit clauses. Yet even where the economics are compelling, the “spirit of the deal” or “social contract” can get short shrift. Though the parties sign the same deal, their minds may not really meet, and the arrangement can fail. Even where deeper assumptions and expectations mesh, a weak or inadequate social contract can poison the relationship. Unforeseen clashes between the economic and social contracts may push the parties apart. This article explores these problems and suggests how to negotiate these twin contracts, the letter and spirit of the deal, so that they are independently strong and reinforce each other.

Consider the fate of a joint venture launched by a national hospital organization and a regional health care provider. Executives at these organizations realized that their two neighboring hospitals 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 facilities within the shared market area. The partners created a governance system, appointed managers, and offered management explicit incentives to maximize the venture’s profits, which would then be shared between the parties. Yet despite compelling economics, the arrangement ultimately dissolved—largely because the partners held different but unspoken assumptions about the joint venture’s purpose, and since the economic contract they negotiated did not fit either partner’s real objective.

Because the national chain had only one hospital in the area, 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 one area hospital—now offering reduced service—would no longer be competitive. Executives at the regional chain, by contrast, saw the joint venture in another light—as a way to extend and rationalize their regional network. They persistently tried to find ways to optimize the efficiency of their overall network (including the national chain’s hospital), but the formal contract and management incentives—to maximize stand-alone JV profits—conflicted with that mission too. Had the parties earlier come to understand each other’s view of the underlying purpose of the venture, they might have forged a more limited, but also more effective, agreement. Such a deal would have ignored possible operating efficiencies but focused on gains from jointly buying practices and building shared feeder facilities in their common market area. As it happened, a clash of underlying expectations and an inconsistent economic contract transformed enthusiasm and potential profits into a swamp of recriminations.

While the economic contract, often captured in a term sheet, is familiar, the “social contract” may be less so in a negotiating context. Since John Locke and Jean-Jacques Rousseau’s clashing views of the proper relationship between a people and their government, the “social contract” has had a very broad political connotation. Our version of this concept takes a radically smaller scale: between two or more negotiating parties. We are not the first to employ these ideas in this way: our colleagues Joel Cutcher-Gershenfeld, Robert McKersie, and Richard Walton explored social and economic contracts negotiated between employers and unions, especially at times of major economic change. In related work on which we draw, economists distinguish written versus “implicit” and “relational” contracts from formal legal contracts; behavioral studies abound of relationships, trust, and unwritten “psychological contracts.” For our purposes, however, the social contract has two levels, both centered on expectations:

The Underlying Social Contract involves the fundamental expectations of the parties about the real nature, extent, and duration of the agreement. For example, are we working out a series of discrete transactions or a real partnership? An acquisition or a merger of equals? A short-term, task-limited venture or an open-ended one? What is the real conception underlying the agreement?

The Ongoing Social Contract involves process expectations for the working relationship and trust, norms for communication, consultation and decision-making, how unforeseen events will be handled, the conditions and means for any renegotiation, and the like.
Drawing on academic studies and our participation in hundreds of different kinds of negotiations, we have developed several propositions about negotiating the letter and spirit of a deal. First, since “hard” tends to drive out “soft,” the underlying social contract is often implicit. Minds do not in fact meet on vital aspects of the arrangement, sowing the seeds of major problems. This is especially true where the parties are from different national, professional, or organizational cultures. Second, productive social contracts may be beautifully worked out—but among the wrong parties. Third, failure to invest in negotiating the ongoing social contract may doom otherwise valuable deals in which the underlying social contract is sound. Fourth, people often view the economic and social contracts as separate; in fact they are closely entwined and should be dovetailed. The social contract is not purely psychological; some of its elements can and should be written down as part of the letter of the deal. Finally, negotiators often treat social and economic contracts as static. Yet both the contracts and the context generally evolve, often quite predictably. The twin contracts should be negotiated and designed to anticipate this likely evolution and take advantage of it.

I. When Minds Don’t Meet: Clashing Views of the Underlying Social Contract.

A Chinese saying on marriage, “same bed, different dreams,” captures the common situation in which a deal is negotiated without a real meeting of the minds on its fundamental nature. Consider four examples in which the surface deal masked fundamentally different conceptions of the underlying social contract.

Discrete Transactions or Partnership? Dan Orum, President of Online Operations at Oxygen Media, emphatically described the “five words I most hate to hear in my business dealings: ‘It’s not in the contract.’” His counterpart’s legalistic words signal a mismatch: what Orum thought was an ongoing, joint problem-solving arrangement is, to the other side, a narrower, customer-vendor transaction. Of course, arms-length deals, in which the issue is mainly meeting contract specs are appropriate to many situations, such as commodity purchases. Yet they are very different from the attitude expressed by a G&F Plastics manager about his firm’s deliberate move with key customers from more traditional customer-supplier deals to a partnering orientation: “When you look for opportunities and solutions, you don’t play by the rules, you make the rules. You invent new ways to add value together. You see things in a different light.”

Autonomy or Conformity? An entrepreneur recently sold her hot boutique enterprise to a very enthusiastic corporate strategic acquirer. Her decision to sell while staying for five years “as the essential player to lead the business to the next level” was animated by visions of her unit’s autonomy turbocharged with the acquirer’s size, global reach, and resources. The responsible corporate executive passionately shared her goal—take the boutique concept global—believed in the entrepreneur, and based on successful experience, had a clear conviction about the highly disciplined corporate procedures necessary to accomplish the global rollout. After the celebratory deal dinner, however, the unhappy reality began to dawn on the seller in the form of a legion of junior staff from HR bearing policy manuals and patronizing lectures on who bought whom.

Even though the provisions of the economic contract—the letter of the deal on economic terms, governance, etc.—accompanying the acquisition were still acceptable, far too little time was spent on negotiating the spirit of the deal in the form of an underlying social contract: a deep meeting of the minds on the real nature of the future combined enterprise, the kind of trajectory needed to reach it, process expectations, and so on. This was not just the standard corporate-entrepreneurial culture clash, though this may be part of the problem. During the complex acquisition negotiations, each side simply projected its own quite reasonable—but incompatible—views and assumptions onto the future enterprise. These discordant ideas about underlying social contract may well poison the working relationship. Chances are, this will be yet one more failed acquisition despite its potent strategic logic, high capabilities and good intentions on both side, as well as the fully acceptable economic contract.

Merger of Equals or Acquisition? The proposed mega-merger between Deutschebank and Dresdner would have produced the third largest bank in the world (with $1.25 trillion in assets), leading many to view it as a landmark in the transformation of Europe’s financial services industry. The two banks planned to merge their retail operations, enabling them to close about 700 branches (of 2500 total) and concentrate on their more profitable corporate businesses. Allianz, a giant German insurer with stakes in both companies, would acquire various assets from Deutsche including their asset management unit.

During the process Deutsche Chairman Rolf Breuer implied that this was to be a “merger of equals,” in line with Dresdner Chairman Walter’s strong preferences. Although the new bank was to bear Deutsche Bank’s name, the corporate color was to be the green of Dresdner Bank. It was important to Walter that “if Dresdner were to lose its 128-year-old independence, it would bow out with dignity and in a partnership of equals.” In particular, Walter was...
concerned that Deutsche would not integrate Dresdner Kleinwort Benson (“DrKB”)—which had contributed more than half of Dresdner’s 1999 pre-tax profits—into Deutsche’s investment banking operations, but would instead sell it. 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 to merge on March 9th, Deutsche apparently decided to sell-off DrKB, believing that its own larger investment banking arm had further global reach. Breuer also didn’t want to engage in a long and expensive integration process with DrKB’s 7,500 staff. DrKB employees moved to a state of alert as soon as they read an anonymous account in the Financial Times by a source who came to be known as “the torchman,” mobilizing their internal factions. In light of this clash—together with growing investor doubts about the basic deal terms and synergies—the deal was called off on April 5 after a furious last round of negotiations, protestations of misunderstanding, and loose compromises seeking to bridge these views. During this process, Deutsche’s share price plunged 19% between March 8 and April 5th. Dresdner’s fell by almost the same amount. Whether inadvertent or by deceptive tactic, clashing visions of the underlying social contract—a merger of equals versus a dominant Deutsche—along with deep business issues doomed the dealmaking.

Operational or Financial Primacy? Divergent views of the underlying social contract may be especially likely when the parties differ in basic ways: small versus large; entrepreneurial versus bureaucratic; centrally managed versus decentralized, finance-driven versus operations-focused, and so on. For example, Northwest Airlines and KLM Royal Dutch Airlines became enmeshed in a strategically potent but embattled “Alliance from Hell.” One major axis of conflict had Pieter Bouew, Dutch President of KLM at one end, who stressed airline operations and the basic deal terms and synergies—the deal was called off on April 5 after a furious last round of negotiations, protestations of misunderstanding, and loose compromises seeking to bridge these views. During this process, Deutsche’s share price plunged 19% between March 8 and April 5th. Dresdner’s fell by almost the same amount. Whether inadvertent or by deceptive tactic, clashing visions of the underlying social contract—a merger of equals versus a dominant Deutsche—along with deep business issues doomed the dealmaking.

In these four cases, minds did not meet on the underlying social contract: transactional or partnership, autonomy or conformity, acquisition or merger of equals, operational or financial primacy. These particular choices are merely examples of underlying social contracts; a wider list that does not begin to exhaust the possibilities would include short-term versus long-term, open-ended versus discrete task-focused, learning versus production-oriented, internally versus externally directed, lifetime versus at-will employment, and so on. In countless deals, like countless marriages, the tangible terms may seem fine to the parties, but only too late and at great cost does the realization grow that each side had and may develop divergent views of the true expectations for the relationship. More prosaically, talks over the economic contract tend to eclipse those over the underlying social one, which remains implicit and unexamined.

Advice: Explicitly focus on negotiating truly compatible views of the underlying social contract; inconsistent perceptions can lead to impasse, conflict, and value destruction during both the negotiation process and the post-deal relationship.

A. Increased Risk in “Cross-Cultural” Negotiations

The ever-present risk of divergent views of the underlying social contract increases when the parties are from different organizational, professional, or national cultures. Such negotiators often make powerful but clashing implicit assumptions. For example, to many from legally oriented cultures, “a deal is a deal” and “a contract is a contract.” To others in more relationship-oriented cultures, the signed deal or contract is clearly understood as simply the starting point for ongoing, further negotiation.

Ming-Jer Chen, Director of Wharton’s Global Chinese Business Initiative, reviewed unhappy experiences of Western firms in China, from Morgan Stanley Dean Witter to the Foxboro Company. Chen concluded that “Because relationships evolve and situations shift, the Chinese perceive contracts as too rigid to take new circumstances into account. Hence there is no stigma to changing the terms of an agreement after it has been signed and Western businessmen can expect to renegotiate or reinterpret points of the contract during their entire working relationship with the Chinese party.” A more blunt lament came from Jurgen Hubbert of DaimlerChrysler: “We saw that we had a contract, [but] we saw our partner try to change the rules everyday.”
Executives in some regions of the world such as North America and Northern Europe tend to be comfortable with dealmaking accompanied by a comparatively modest relationship, while a more extensive relationship is often required to support negotiated agreements in other regions such as East Asia, Latin America, and Southern Europe. This can imply different levels of emphasis on the underlying social contract. In turn, this raises broader, related questions: can the joint arrangement be understood primarily as a business relationship or is it more personal and social? Are relationships with employees, customers, and suppliers primarily understood in economic terms or are they more complicated? Many sources exist to systematically review potential problem areas in cross-cultural negotiations, but the point here is to underscore the fact that divergent national and organizational cultures should raise warning flags about social contract alignment.

While NCR Japan was American-owned, it had a history of stable, lifetime employment and a “company union” that enjoyed close relations with management. When a new U.S. plant manager arrived and instigated downsizing in certain units he saw as overstaffed—although the plant was profitable overall—employee resistance soared to this perceived violation of the underlying social contract. A second union was quickly organized which took a far more adversarial approach, driving labor costs up sharply and insisting on job guarantees. Local suppliers refused to do business with the plan, seeing it as untrustworthy. A full decade after the plant manager was ousted, both the second union and the supplier boycott continued.

Not only does this instance underscore cross-cultural risks, but also how strongly negative reactions can be to perceptions that the social contract has been breached. Yet all breaches need not be fatal. Whether a felt breach results from cultural or other sources, how it is handled can strengthen or even rupture the social contract. For an inadvertent breach, managers should act to acknowledge the perception and reassure the other side that the “violation” was unintentional, not exploitive. Then sincere efforts to rebuild confidence can have the effect of buttressing and advancing the social contract.

Marriage Partner or Economic Asset? A classic, culturally-driven case, to which we will return for further insights, involved the strong ties built between Honda and Rover over their 14-year history beginning in 1979. Despite an illustrious history, by the mid-1970s, Rover possessed dated and unprofitable car lines, poor quality, low productivity, and bitter labor-management strife. Honda wanted to learn about aspects of Rover’s design and to gain experience in the European market. From an initially simple licensing deal, the terms of their economic contract grew more elaborate, including reaching an apex when in 1988, after British Aerospace had acquired Rover from the U.K. government, Honda (U.K.) and Rover swapped 20% equity stakes and board seats. The underlying social contract similarly grew in fits and starts from wary tolerance into mutual embrace that Honda, at least, expected to continue indefinitely. Honda openly shared its manufacturing and management processes with Rover. In everything from labor relations to technology, a more and more willing Rover saw itself as having been “Honda-ized,” and the results had generally been good for both, with dramatic quality and productivity increases for Rover.

Rover’s new parent, British Aerospace (BAe), unexpectedly executed a deal to sell Rover to BMW in 1994. The BMW-BAe covert operation to purchase 80% of Rover, recounted as “one of the most daring corporate kidnaps of recent years,” shocked and deeply upset Honda. The deal happened fast and largely in secret from both Honda and Rover, “a sting of Paul Newman proportions.” Beyond the sheer surprise and anger of many Rover constituencies—most of its management, its unions, and the British government—headlines rang out in Japan: “How Could a Western Ally be So Unreliable?” In Honda’s eyes, “British firms do not attach much value to relationships built up over many years … The sudden dropping of one business partner in favor of another is anathema to [firms like Honda]… and is liable to cause serious and long-term offense.” Yet, BAe held a dramatically different view of the social contract with Honda, viewing Rover as an economic asset to be dispassionately maximized, with the BMW deal as the best means for doing so. While an implicit, marriage-like underlying social contract had developed between Honda and Rover at the operational level, there was a basic disconnect: economic decision rights and ownership were vested at the parent (BAe holding company) level, which had no such understanding with Honda.

Advice: Be especially alert to possible divergencies in views of the underlying social contract when the parties are from different organizational, professional, or national “cultures.”

B. When the “Wrong” Minds Meet

Like the Honda-Rover-BMW experience, failure to ensure that the “right” parties see the spirit of the deal similarly is surprisingly common across diverse situations. For example, senior and working levels may have sharply different views of the spirit of an agreement in practice. A CEO-to-CEO negotiation over a strategic partnership—
say between a retailer and supplier—may stress the importance of many dimensions of cooperation, the mutual im-
portance of service and quality, and the long-term time horizon of the joint effort. Yet, at the level of the actual
retail buyer—mainly compensated on the basis of quarterly numbers—ritual references to “our strategic partner-
ship” may primarily be used to beat price reductions out of the supplier’s sales contact. The real “solution” to this
frustratingly common problem does not usually consist of greater negotiating skill on the part of the purchaser, al-
though finding internal allies within the retailer who can exert pressure on the buyer can greatly help. More funda-
mentally, senior retail executives need to reset both incentives and expectations at the working level at the time they
forge what they see as a strategic alliance.

Other, less obvious, ways exist to “leave out” key parties from new social contract understandings. For exam-
ple, in 1988 Komatsu Ltd., Japan’s leader in earth moving equipment, and the American conglomerate, Dresser In-
dustries, combined their North American engineering, manufacturing and marketing efforts, hoping to attain what
they called “A Mountain of Treasure.”* Dresser sought Komatsu’s new design technology and a cash infusion for
plant modernization and capital expenditures. Komatsu wanted added capabilities and better North American mar-
ket penetration to become a successful global player. While seeking to preserve parallel brands and distributor-
ships, the Komatsu and Dresser created a 50/50 joint venture (Komatsu-Dresser-Corporation or “KDC”), main-
tained equal management representation on the six-person oversight committee, and committed to $200 million of
new joint investment. Beyond the economic terms of their arrangement, they sought to foster a strong social con-
tract between the two management teams.

Unfortunately, their traditionally competitive dealers were not party to the new social contract and only intensi-
fied their rivalry, which spread into the JV. Over time, dealers found it difficult to get reliable information from
headquarters about parts or warranty coverage. Despite last-minute efforts to bring in industrial consultants and
conduct employee-swaps, the dealer conflicts intensified. KDC market share declined sharply, losses mounted, the
KDC workforce was cut from 5000 to 3000, and the venture was ultimately dissolved. In effect, by leaving poten-
tially blocking groups, such as the dealers, out of the new social and economic contracts, KDC opened up whatever
strategic promise there was in the new venture to attack by determined internal opponents.19

While a strong social contract should generally be forged among all the “right” parties, such an outcome may not
be in the interest of all. For example: Honda was so focused on its social ties with Rover that, arguably, Honda was
blinded from taking seriously or blocking BAe’s moves to sell Rover to BMW. For a BAe focused on maximizing
the sale price of Rover, the “marriage” presumed by Honda and Rover offered the negotiating maneuver room ulti-
mately required to sell Rover without triggering effective blocking action. There is a cautionary tale here: don’t be
so caught up in an assumed mutual relationship that you fail to see how other influential players may exploit your
situation. The broader point, however, stresses appropriate involvement.

➤ Advice: Cast a wide net and negotiate the appropriate social contracts with the “right” set
of parties, being sure that a meeting of the minds on the spirit of the deal is forged among
these potentially influential parties to the future arrangement.

C. When Third Parties Drive the Deal

A related failure to develop a positive social contract among the right parties happens when one team, such as
the business development unit, negotiates an alliance or acquisition by a heavily price-driven process with a strong
legalistic component. When this is done, the team then “throws it over the fence” to operational management with
the unenviable job of forging a strong, positive social contract after the fact. Almost always, prior operational in-
volvement would have been preferable. Jerry Kaplan, founder of GO Technologies, was especially critical of the
process his firm experienced around negotiating a complex IBM investment in GO. As Kaplan saw it, “Rather than
empowering the responsible party to make the deal, IBM assigns a professional negotiator, who knows or cares little
for the substance of the agreement but has absolute authority....” The negotiator begins by assembling a list of all the
interested internal constituents, all of whom are free to add new requirements...or block some minor conces-
sion....20v With such a negotiating process, the chances are small of the right minds truly meeting on the underlying
social contract.

In some cases, investment bankers or other dealmakers with a powerful interest in making a transaction hap-
pen—for better or worse—can divert the principals’ attention from possibly fatal divergencies in their views of the
underlying social contract. For example, Matsushita Electric paid $6.59 billion for MCA—owner of Universal Pic-
tures, record companies, and theme parks—its rationale was a deep concern to ensure a steady flow of creative
“software” for its global hardware businesses. Senior MCA management agreed to the acquisition largely in the
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expectation that its new, cash-rich Japanese parent could provide capital for vital initiatives such as acquiring more record companies, a network, and so on, needed to compete with its rivals like Disney and Cap Cities/ABC. To get the deal done, however, Mike Ovitz, the unorthodox corporate matchmaker, successfully contrived to keep the parties mostly apart during the process, managing expectations separately on each side, and building momentum until the deal was virtually closed. Each had a distorted projection of the other’s real intentions, leading to post-deal friction and the sale of MCA a few years later to Seagram, at a substantial loss to Matsushita both in money (¥165 billion) and face. Yet neither side did a determined, independent “due diligence” on perceptions of the real underlying social contract, in part given the cultural chasms dividing old-line industrial Japan, creative Hollywood, and the New York financial community—but heavily due to the role of a third party.

Advice: Be especially alert to potential discrepancies in the principals’ views of the underlying social contract when third party dealmakers drive the process.

To summarize our first set of propositions: inconsistent or negative views of the underlying social contract itself by the involved parties can lead to impasse, conflict, and value destruction both during and after the negotiation process. This suggests that, during the dealmaking process, the parties should earlier, more explicitly, and more effectively focus on negotiating a true meeting of the minds on their social contract, as well as on the terms of the economic one. They should be especially alert to possible divergencies in views of the social contract when the parties are from different organizational, professional, or national “cultures.” And finally, negotiators should be sure that that a meeting of the minds on the spirit of the deal is forged among the right set of parties to the future arrangement. Red warning flags should go up when third parties, such as bankers or business development units, drive the dealmaking and subordinate the role of the principals who must make the deal actually work.

II. Making a Done Deal Actually Work: Negotiating the Ongoing Social Contract.

Virtually any seasoned executive knows the vital importance of negotiating a good working relationship in realizing the potential of agreements. As Jerry Kaplan argued, “[Lawyers] tend to confuse ‘the deal,’ the working understanding between two parties, with ‘the contract,’ the written words that attempt to capture that understanding at a point in time. Words are good for capturing some things, such as the rules of chess, but not for others, such as how to ride a bicycle. What makes deals work are not the written words but...personal relationships between the individuals charged with making them work.”

Informed by the economic deal as well as the underlying social contract, the ongoing social contract includes the crucial working relationship and trust, but many more ingredients of success as well: broader process expectations for how the parties will interact, norms for communication, consultation and decision-making, how unforeseen events will be handled, conditions and means for renegotiation, and the like. Needless to say, these factors take management time and focus to bring into being in a productive manner. Indeed, well before the ink is dry on the deal, these expectations are tacitly being negotiated. Dick Allen, Sun Microsystems’ Global Commodity Manager for Memory, oversaw a billion-plus dollars of purchases annually from many suppliers, and focused primary attention on the ongoing social contract:

“[Allen stated that] ‘Both Sun and our suppliers sign a letter of agreement and put it in a drawer.’ He likes to keep his agreements down to 3 or 4 pages, as opposed to the 30 or 40 page documents the legal staff would prefer in order to cover all contingencies. The Commodity Team feels that the key to a successful ongoing relationship is based on trust that has been built up over many years rather than in the words of a legal contract.”

Sun shares a lot of technological and strategic information with its suppliers. This relationship is not based on contracts or monetary exchange during the development phase, but on the common goal of profitably bringing new technology to market.

Negotiating the ongoing spirit of the deal requires shaping attitudes and expectations but also creating tangible business processes to make the agreement productive. For example, the Bose Corporation has taken a conscious approach to integrating very intimately with key suppliers. This integration has become a source of competitive advantage. In doing so, as many as nine of their suppliers have “in-plants,” supplier employees who work full-time at Bose in some amalgam of roles as salesperson, purchasing agent, and planner and who are empowered to act on behalf of Bose and the supplier.

Experienced managers widely view trust and good working relationships, relative to elaborate contracts, as value-creating qualities. A number of academic studies validate the potential advantages that “self-enforcing” un-
understandings and “relational” contracts can have over explicit legal contracts, though, as we argue later, the letter and spirit should strongly complement each other. In a fast-changing world, a positive ongoing social contract can foster efficient sharing of information and know-how; lower the costs of complex adaptation; permit rapid exploitation of unexpected opportunities without the cost and delay of trying to write, monitor, and enforce complete contracts; as well as reduce transactions costs and fears of exploitation more generally. For example, Jeffrey Dyer in an extensive 1997 study of North American and Asia automakers and suppliers found that “General Motors procurement (transaction) costs were more than twice those of Chrysler’s and six times higher than Toyota’s. GM’s transactions costs are persistently higher …because suppliers view GM as a much less trustworthy organization.” Analogous positive performance results have been found in the electrical equipment industry and among Silicon Valley firms.

Forging and Breaking an Ongoing Social Contract: Honda-Rover-BMW Revisited. [Note: this example could be boxed] In tandem with their evolving economic contract, Honda and Rover took explicit steps over 14 years to build a productive ongoing social contract. They swapped English and Japanese engineers and frequently committed senior staff to high-level, frank, problem-solving summits and overcoming cultural misinterpretations. By the late 1980s, Honda was sharing and Rover enthusiastically adopting many of the Japanese carmaker’s work and management practices as well as vital process and design technologies. Modeled after its relations with Honda, Rover built an internal social contract with its workers, a so-called “New Deal,” adopted by management, union negotiators, shop stewards and the workforce in 1990 in which production workers received the same benefits (e.g., sick pay, salary, one month’s notice of dismissal, common eating areas, etc.). The new social contract led Rover managers to share sensitive information about production targets, trends and quality problems with production line workers. The employees responded, huddling together on the shop floor to brainstorm solutions, at times taking problems home to puzzle through solutions. These collaborations contributed to major economic improvements for Rover: from a miserable, pre-Honda history, sales rose 50%, exports climbed 15%, unit costs decreased dramatically, product cycles were shortened and defect rates fell precipitously. Whereas in 1988 Rover’s sales revenue per employee (in thousands of dollars) stood at 46 (v. 371 for Honda and 630 for Toyota), by 1993 it reached 209, surpassing General Motors’ level of 174.

BMW’s stunning acquisition of Rover by way of its corporate parent, BAe, staggered both Honda and Rover. However, given how the Land Rover would complement BMW’s product line plus many cost saving opportunities, analysts were overwhelmingly positive: “BMW bought an absolute gem,” “The purchase of Rover combined impeccable strategic logic with short-term earnings enhancements…” Such recommendations helped drive BMW’s share price up by 13% over the two weeks following the announcement. To realize these apparently huge potential strategic benefits, BMW sought to negotiate a new social contract with resentful Rover management and unions. BMW pledged to keep Rover as a separately managed British company, while setting up several Rover-BMW joint committees. Yet BMW could not play the long-accustomed role of Honda nor did BMW-Rover expectations about ongoing interactions mesh.

Rover’s performance, long on the upswing, plunged. Within two years, BMW abruptly changed tack, replacing all Rover senior executives, and prompting headlines in the British press: “BMW men grab the wheel to steer Rover.” The remains of the ongoing social contract that had been meticulously built-up by Honda and Rover, was quashed; BMW imposed a more traditional and hierarchical model. Frustrated BMW executives commented, “Rover’s strengths seem to be the creation of unnecessary friction, a disappointing no-risk attitude and an amazing display of egoism.” Rover management responded, angrily asserting no intention of “rolling over and having our bellies ticked.”

Rover’s labor relations, market share, and financial results only got worse. By March 2000, after pouring an additional $3.4 billion into Rover, and after BMW’s hitherto golden CEO Pischetsrieder had been ousted mainly over this acquisition, BMW sold off most of what it now bitterly referred to as the “English Patient.” While strategic, macroeconomic, and other business factors contributed to this unhappy result, the Honda-Rover experience underscores the value of a positive ongoing social contract on economic performance while the BMW-Rover trauma suggests the high costs of a negative one.

Companies entering into longer term agreements such as joint ventures or strategic alliances often allocate a massive amount of time to the initial dealmaking to forge the initial economic contract. After such an exhausting ordeal, it is natural to deploy a much smaller fraction of senior executive time to ensure compatible underlying and ongoing social contracts. In fact, whether a promising deal will in fact work out may depend upon explicit pre-deal attention on the social contract and early, sustained investment of senior executive attention on the ongoing social contract.
Conscious efforts to shape the social contact, discussing what and how the parties expect to communicate over time, can help stave off later problems. Straightforward practices such as creating shared operating principles that govern confidentiality, information exchange, the creation and use of intellectual property, and dispute resolution systems can build needed trust and stability and give the partnership the proper launch. To minimize the risk of a debilitating "we-they" split, the parties should also explicitly discuss how decisions will be made when differences inevitably emerge. For example, one party to an agreement might tacitly expect that the other partner will give it the option to participate in related ventures and advance warning of deals the company is doing in similar industries or regions. The counterpart may have had no such expectation. If this difference is not addressed early on, the first announcement of a related business venture with another party could open up a gulf of mistrust. If such a "breach" inadvertently occurs, it should be consciously managed as a way to rebuild shared understandings, not demonize the other side. Similarly, it is good to negotiate mutual understanding of the circumstances that could trigger a reconsideration or even renegotiation of the agreement, as well as the means by which such a process would be carried out. Since elements of the ongoing social are often negotiated tacitly at some risk of a costly disconnect, explicit expectation-setting can make a major positive difference.

Advice: Even as the economic and underlying social contracts are under negotiation, act to develop a productive ongoing social contract, which involves the working relationship and trust, as well as other key process expectations. Consider an explicit "audit" of all side's perceptions of the ongoing social contract and continual action to ensure that it is positive.

III. Dovetailing the Social and Economic Contracts.

In its lengthy strategic alliance with Rover, Honda seemed to assume that the relationship was almost equivalent to a marriage. As such, Honda freely shared much of its valuable technology and process knowledge with Rover. Yet Rover’s parent, BAE, did not view the Honda relationship this way at all. Key terms of Honda’s economic contract were inadequate to the reality of BAE’s sharply different perspective: no last-look provisions, no right of first refusal for stock sales or change of control, no effective protection from a rival automaker of embedded technologies. Any of those or other similar provisions might have enabled Honda to block BMW’s acquisition of Rover by energizing potentially opposing parties—Rover management, labor, the U.K. government—before the sale was a fait accompli. That BAE would actually carry through this sale was inconceivable to Honda—and its formal economic contract did not provide effective tools to block the action. This unhappy result for Honda underscores the importance of mutually supportive social and economic contracts (as well as a careful “audit” of the relevant parties’ views of the spirit of the deal).

The broader point is the importance of a fit between the letter and spirit of a deal. Sometimes this should be obvious: a discrete, project-oriented agreement should have clean, workable exit and termination provisions linked to both side’s understanding of the point when the objective is accomplished. To cement a commitment to total discretion in the Wal-Mart-Proctor & Gamble alliance, which grew from $350 million to a billion dollars in ten years, the alliance team members signed confidentiality agreements. This confidentiality became an “insurance policy” for senior management, protecting the nascent working relationship, and leading the parties to share closely held information necessary to realizing joint gains. In other cases, if a central objective of an agreement is ongoing transfer of knowledge, researchers have found that an equity position tends align incentives better and be more conducive to success than contractual provisions. Or, suppose that the economic contract under negotiation between independent upstream and downstream parties in a value chain proves too laden with conflicts and difficult-to-align interests to achieve mutually desired cooperation. In such cases, the parties should often consider a completely different economic contract—an outright acquisition of one by the other—to internalize the conflicts and better achieve the underlying objective.

Advice: Strive for a good “fit” between the social and economic contracts.

It can be tempting to regard the social contract as unwritten and psychological and the economic contract as written and tangible. Yet the two can be productively dovetailed, with elements of the economic contract directly tied to the social contract. In an intriguing example, sharply contrasting to the Rover-BMW case where changes to the social and economic contracts led to collapse, Chrysler deliberately restructured both the letter and spirit of its contracts with suppliers to save its business. In the late 1980s, Chrysler faced mounting losses, a projected $1 billion overrun on its newly launched LH program, a $4.5 billion unfunded pension fund and a record loss of $664 million in the fourth quarter of 1989. To stop the hemorrhage in late 1989, Chrysler set out to revolutionize its sup-
plier relationships, which had traditionally harnessed the power of competition among as many qualified suppliers as possible through bidding. From the old “lowest qualified bidder” model, the new intended social contract could be described as an “integrated long-term partnership” in which the partner was expected not only to improve its own performance but also to enhance Chrysler’s operations beyond the supply relationship. The new social contract was supported by a number of provisions of the economic contract.

**Selection.** From its long-time approach of choosing the “lowest price of qualified bidders meeting specs,” Chrysler moved to pre-qualify a subset of suppliers (cutting from 2500 suppliers to 1140) based on advanced engineering, manufacturing capabilities and past performance. Within this pool, suppliers were chosen based on their past design and manufacturing performance and their record of on-time delivery as well as price.

**Scope of contract.** By working with a smaller set of players, Chrysler shifted from a system in which multiple suppliers competed over separate design, prototype and production contracts to one in which a single supplier held primary responsibility for the combined design, prototype, and production of a component or system.

**Contract duration and renewal.** Under the old system, there were no renewal expectations and average supplier contracts were 2.1 years. The new approach saw average contract life increase to 4.4 years with Chrysler giving oral guarantees to more than 90% of its suppliers that the current business remained with them at least for the life of the relevant model if performance targets were met.

**Price.** In the old system, the lowest qualified bid won, regardless of implications for supplier profits. Under the new social contract, Chrysler sought to ensure a fair profit for both supplier and buyer. Instead of relying on commodity pricing to squeeze its suppliers, Chrysler adopted a target costing approach that worked backwards from total cost to end user in order to calculate allowable costs for systems, subsystems and components.

**Accountability and Performance Evaluation.** Under the old system, suppliers were accountable for timing, quality, and other elements of arm’s length contract performance. Under the new system, evaluation reached well beyond the economic contract and supplier organizational boundaries to innovation, coordination, relationship-specific investment, and value chain improvements. In fact, Chrysler formally expected its suppliers to look beyond their own operations and to find cost-saving possibilities within Chrysler itself equal to at least 5% of contract value, fully half of which would be shared with the suppliers. Such savings could be very large; Magna International, for example, submitted proposals for savings that realized in excess of $75 million one year.

With a new social contract emphasizing “longer-term, integrated partnership,” consciously defined and reinforced by an amended economic contract, the time Chrysler needed to develop a new vehicle approached 160 weeks, down from an average of 234 weeks during the 1980s. The cost of developing a new vehicle plunged 20% to 40% during the 1990s with profit per vehicle jumping from $250 to a record of $2110 in 1994. These results were significantly driven by forging a new social contract deeply intertwined and reflected in the new economic one.

**Advice:** Resist the temptation to treat the social contract as unwritten and purely subjective with the economic contract written and objective. Properly dovetailed, many of the expectations of the underlying and ongoing social contract can and should be embodied in mutually reinforcing economic agreements.

### IV. Negotiating Twin Contracts that Anticipate Change

In planned and unplanned ways, negotiated arrangements change and face change. For Honda and Rover, a simple licensing agreement evolved through many higher-value stages to become a tightly integrated relationship with cross-shareholdings and board memberships, until disrupted by the BMW deal. Unfortunately for Honda, the protective features of its economic contract fatally lagged the developing social one.

Consider the extent to which the twin contracts changed across a superficially similar automotive saga. Ford, Mazda, and Nissan signed a 50-25-25 agreement in 1969 to manufacture automatic transmissions and offer U.S. market access to the Japanese partners. As shared experience and trust grew—with regular meetings of U.S. and Japanese alliance teams alternating between the two countries—that agreement became the platform for developing a host of subsequent worldwide opportunities. For example, Ford purchased 15% of Kia Motors, matching Mazda’s share of that Korean firm, and both used this entity as a base to source inexpensive small cars. Mazda provided
design and manufacturing input to a new Ford plant in Mexico. By 1992, following many more joint projects, the bond grew even closer when Ford acquired 50% ownership and management control of Mazda’s U.S. plant. By now, the two companies had worked jointly on ten current models; 25% of Ford’s models sold in U.S. had Mazda input, and 40% of all Mazda models had Ford input. When Mazda fell into crisis in the mid-1990s, the positive social contract built over 20 years enabled a remarkable development. Prodded by Sumitomo Bank, Mazda’s principal creditor, Ford purchased a controlling stake in Mazda and a Ford executive, Henry Wallace, was named the president of the $19 billion Japanese company in order to engineer a turnaround – the first foreigner ever to run a major Japanese corporation and a nearly unthinkable outcome absent the shared history and positive social contract.

While these cases from the automotive industry suggest how dramatically the letter and spirit of agreements can develop in response to new opportunities and challenges, the implication is far broader. The changing relationship between Timberland and City Year illustrates the conscious management of a evolving social and economic contracts, starting with a purely “philanthropic” arrangement: a one-way, check-writing or in-kind deal such as 50 pairs of Timberland boots to City Year, an urban initiative. Timberland’s COO, Jeff Swartz, remarked: “Our expectation was a thank you note and a small sense of self-congratulations and nothing more.” Our colleague Jim Austin describes how this limited collaboration grew to a more “transactional” relationship involving the shared expectation that each would search for mutually beneficial deals such as cause-related marketing, event sponsorships, and City Year-organized community service projects for Timberland employees. Finally the relationship became “integrative,” with the expectation of an ever-widening set of personal and organizational connections and a subsequent meshing of organizational missions and values. Timberland executives joined City Year’s board of directors while City Year has offered diversity and team-building training to the firm. Community service has become an integral part of Timberland’s strategy and culture, with every employee getting up to 40 hours of paid time-off annually for service-oriented activities. Timberland has assisted City Year in financing, operations, and recruiting additional corporations to enable it to expand its operations nationally. This evolution has created great value for both sides.

Given likely evolution of the social and economic contracts, managers should recognize the need to re-negotiate terms over time. Instituting metrics and mechanisms to evaluate the contracts’ actual performance can enable learning and adjustment along the way. This requires regular monitoring as well as advance agreement over what types of conditions might trigger the re-negotiation; such conditions could changes in contributions that would lead the parties to adjust the distribution of value.

Advice: While many negotiated agreements are clearly time- and task-limited, it is often a mistake to treat social and economic contracts as static. The likelihood of new challenges and opportunities calls for the expectation of change and deals designed for evolution.

A. Designing Agreements for Predictable Change in Circumstances and Attitudes

Benetton, the Italian apparel-maker, successfully entered a large number of new markets by a characteristic multi-stage process: establishing a local agent to develop licensees for products from Italy, developing local production capability, partnering with a local firm for further market development, then, if successful, buying out its partner, which typically retained a significant role, and integrating this foreign subsidiary into Benetton’s global network. Key to this staged approach were dovetailed social and economic contracts that embodied clear expectations of this planned trajectory with local partners and that included formal mechanisms to accomplish it.

Anticipating Buyout or Exit. Yet the kind of smoothly intended transitions often achieved by Benetton, can be marred in other cases by clashing expectations and conflict. Poor negotiations can result in high-status local partners who feel betrayed and devalued by “unexpected” buyout initiatives, unworkable valuation formulas that led to disagreement and impasse, and the like. No successful private equity or venture capital firm would invest without negotiating clear exit expectations, along with the necessary contractual provisions, when appropriate milestones had been met or circumstances required. Similarly, some joint ventures with up-front options for one party to progressively acquire greater shares over time are often better understood as staged sales after the parties have become more familiar with each other, reached interim goals, and assessed value. Without well-designed provisions, these sorts of arrangements can lead to costly stalemates as each party maneuvers to build leverage. In some cases, when the venture has been very successful, the producing partner, for example, is forced to buy out the marketing partner at a multiple of the price that would have satisfied the marketing partner had the exit provisions and expectations been negotiated up-front.
Just as it is unhappily common for people to die without wills or (first) marriages to lack pre-nuptial agreements, many partnerships and ventures lack a workable way out. Sometimes, incredibly, this lack is by design. AT&T and British Telecom, for instance, formed Concert, a massive 50-50 joint venture of pooled assets to provide international telephone and internet service; AT&T for example, contributed its 50 largest international customers. AT&T and BT sought to force themselves to make Concert work, in part by ensuring that the venture contained no exit provisions, not even routine arbitration. At the point during which their three-year cooperation seemed irretrievable and was losing £150 million per quarter, however, AT&T and BT decided to part. Without exit provisions or procedures, this led to nightmarish negotiations to unwind 21 subsidiary ventures in 230 countries, 47,000 miles of fiber optic cable, at least a billion dollars in new technology investments, as well as headquarters with over 400 staff—all in an soured atmosphere of failure and the keen knowledge that each party would need these international assets for its post-Concert strategy.

Just as buildings require a sound foundation, long-term relationships call for well-structured exit provisions. It is easy to incorporate all-or-nothing exit clauses like “Texas shoot-outs” in which one party names a price and the other party is required to be a buyer or seller at that price. While simple and sometimes appropriate, this kind of mechanism can encourage opportunistic behavior when one party is illiquid and can be used by larger partners to pressure smaller ones. Boilerplate arbitration or buy-sell deals may also be inadequate to real breakup needs. More sophisticated exit provisions should provide procedures and timetables to compensate each party for contributed assets and to allocate shared assets such as customer relationships and intellectual property. Beyond valuation procedures and formulas, structured mediation, arbitration, and other alternative dispute resolution mechanisms can be highly useful. While it can be difficult to for companies falling in love to simultaneously negotiate pre-nuptial agreements, it is often helpful to have different people negotiating exit provisions from those working out the constructive future venture. If the lawyers or business people are attuned to the nature of the venture and what would actually be involved in its termination, they can craft appropriate provisions.

**Anticipating Shifts in Attitudes.** While savvy dealmakers generally ensure workable exit and buyout mechanisms, they may pay less attention to likely changes in one or more parties’ attitudes toward the deal over time—that may be sharply at odds with the economic contract and even erode the deal’s value. For example investors and founders in new ventures typically anticipate a period of cooperation with shared interests in growing the firm and enhancing its value. Both parties may find common ground in negotiating early capital investments or marketing strategies with longer-term payoffs. In time, though, the equity investors typically will plan for an IPO or sale. While the founders may keep a long-term growth perspective, investors may be much less enthusiastic about investments that do not promise quick, low-risk increases in valuation. Investors and managers sometimes personalize this built-in, predictable conflict—with silent or shouted accusations like “short-term bean counters” or “financial leeches” versus “empire builders” and “economic illiterates”—that can take a real toll on results and relationships.

Experienced investors sometimes foresee this likely divergence of interests over time and seek to ingrain—from the beginning—a social contract that anticipates and detoxifies it. During negotiations and perhaps even at the deal-closing dinner, an investor may underscore the good feelings and good intentions of both sides, describe the predictable shift, and offer the firm expectation that when each side is unhappy with the other, they will work together without negative personal attributions “since the conflict will come from economic interests that no longer coincide,” not from defective partners. Even where governance provisions are well-suited to investment and exit, inoculation against this predictable problem by conscientious social contract negotiation may prove quite beneficial.

**Anticipating Likely Shifts: A Tale of Two Investors.** We like to contrast two cases, negotiated by different investors during the same year, in which subsequent attitudes toward the deal played key roles. The first involved prominent pediatricians who were looking for financial and other assistance to make a series of innovative interactive CDs on parenting issues. A venture investor provided capital in return for a substantial interest in the new company that would own all of the doctors’ efforts in this business area. The investor then helped the doctors create a demo CD, wrote a business plan and marketing material, and then brought the demo CD and the plan to the attention of key people at major software publishing houses. When major publishers expressed enthusiasm, the doctors surprised the investor by arguing that “he owned too much of the company,” that “their ideas and reputation were the company” and that he should voluntarily reduce his stake in the company. Given his work to develop the company, he was stung. When strenuous efforts at resolution ultimately reached impasse, the new company languished and the doctors were blocked from developing these ideas elsewhere. In retrospect, it was clear that the two sides had neglected in advance of actual economic success to seriously work through different scenarios to test the perceived fairness and psychological sustainability of the deal, firm up their social contract, and alter the economics if necessary.
In contrast, another investor was approached by a commercial banker who financed independent filmmakers, normally a risky business. Yet, the banker had not lost money on any of his 41 such loans. He did so in part by nurturing worldwide contacts and then advantageously pre-selling foreign rights. Unhappy with his compensation as a bank employee and now planning to leave, he was seeking an $18 million investment in a new film finance company to complement the $2 million he himself would invest. He offered an equity investor 90% of the new company. The investor’s analysis projected a 100% annual rate of return on this investment. The investor turned this attractive offer down, counter-proposing a new deal that, perhaps surprisingly, was more lucrative for the banker and less so for himself. The investor reasoned that, in two or three years, he would have simply taken the place of the bank, providing little but “commodity capital,” and the banker-turned-entrepreneur would be seeking a better deal from new sources of capital. Therefore, his offer contained a series of results-linked options: for the banker to buy back some of the investor’s equity at a relatively low price after the investor had received his first $5 million, the option to buy back more of the equity after the investor had received the next $5 million, and so on. At each point, under this deal structure, it would be in the banker’s interest to stay in the relationship than to start out on his own again. The investor’s projected rate of return on this offer was closer to 30%. But the investor preferred a 30% return that he believed would actually receive to an illusory 100% return on paper but that provided the banker with incentives to abrogate at some point.

Unlike the first investor who backed prominent doctors to make CDs by way of an economically sensible but perhaps psychologically naïve deal, the second investor structured his proposal explicitly to match predictable changes in circumstances and likely attitudes. When human capital is a central contributor to success, matching the economic contract to predictable shifts in power over time is vital. Dovetailing this structure with explicit discussion of the nature and duration of the relationship to establish a compatible social contract – “I expect that, if we are successful over the next seven years, you will have taken our stake down to 25% and that you will buy us out entirely after 10 years” – can prove highly mutually beneficial.

» Advice: Think through the likely future evolution of agreements and accompanying attitudes.
  Design economic agreements and negotiate expectations that productively anticipate foreseeable changes in circumstances.

B. “Multiplex” Agreements to Protect Against Likely Vulnerabilities

Forging an agreement with a single party on the other side and/or over a single issue sets up what can be called a “simplex” arrangement that is often quite vulnerable. For example, complete implementation of the spirit of Sadat and Begin’s Camp David agreement—to fully normalize Egyptian-Israeli relations—was highly dependent on the commitment of specific individuals. When Sadat was assassinated, momentum was lost and only the letter of the deal, a “cold peace,” remained. When Ben Cohen and Jerry Greenfield negotiated with Unilever over selling their social responsibility-oriented ice cream firm, Ben & Jerry’s, the Unilever executive in charge of the deal was highly sympathetic to the essence of their unconventional strategy. This smoothed the process, but when his involvement terminated, the sellers felt that, despite legal guarantees, their firm was hostage to the alien values of the multinational.

Reducing such simplex vulnerabilities to single parties calls for a negotiating strategy that consciously “multiplexes” parties and issues to deepen and broaden commitment to the deal. For example, senior partners in strategy consulting firms often depend primarily on their relationships with CEOs or group presidents in client companies; not incidentally, these relationships confer great power on the top consultants. But if the CEO or group executive leaves, the consulting firm may be removed. A far more sustainable relationship with clients involves the very conscious negotiation of an expanding web of involvements and dependencies within the client corporation at the top, secondary executive, and operational levels—even where the consulting projects might most “efficiently” be completed among a smaller circle. One executive, whom we’ve advised, not only wines and dines a range of people within a particular customer organization, but also strives to broaden the types of relationships he fosters. He links this customer to other businesses owned by his parent company, invests money in a range of joint projects, and makes introductions for them to some of his other key customers, all to develop multiple, enduring points of contact. In a public sector context, to protect against cuts, the Pentagon sometimes carefully spreads lucrative subcontracts for major procurements across many congressional districts, especially those of influential committee chairs. In this way, when the budget-cutters attack, a massive resistant coalition in favor of the weapons system can be mobilized.

Analogous multiplexing strategies can help protect commodity businesses that would otherwise be vulnerable to better prices offered by others. By becoming much more tightly integrated with their customers’ operations and
providing a web of customized services, their deals both generate higher value to each side and are far more sustainable in the face of price-based attack by competitors. Not only are the gains harder for a competitor to match, but switching costs are higher.

**Advice:** Consider multiplexing both parties and issues of a potentially vulnerable agreement to broaden and deepen its supporting coalition and to weave an interest web that is harder to dislodge.

V. Avoiding Misconceptions in Social Contract Negotiations

When the right minds do not truly meet, agreements are at risk. Negotiating the right spirit of a deal, in part by making implicit expectations explicit, can minimize this danger. Each side should come to share a view of the social contract, which productively dovetails with the economic contract. The chances of an explosive mismatch go up when the parties come from different “cultures,” when there are multiple stakeholders and organizational levels, and when third parties drive the deal process. In negotiating alignment, savvy dealmakers avoid six common misconceptions about the social contract:

- **Misconception #1:** “The social contract is primarily about the working relationship.” **Reality:** While the ongoing social contract embodies the working relationship, it also consists of expectations about communication, consultation and decision-making, as well as renegotiation. The underlying social contract consists of expectations about the fundamental nature, extent, and duration of the deal. The spirit of the deal includes both the underlying and ongoing social contracts.

- **Misconception #2:** “The term ‘social contract’ inherently implies a relationship that is cooperative, democratic, and participatory.” **Reality:** While the social contract can mean those things, it need not. Instead, it is intended as a neutral term about each side’s expectations, which can range from “egalitarian” to “autocratic” and from “equal sharing” to “eat what you kill.”

- **Misconception #3:** “The term ‘social contract’ implies a shared view.” **Reality:** While a shared view is generally desirable, different side’s perceptions of the social contract can diverge wildly, unless negotiated into productive alignment. These divergencies can be fatal to an agreement.

- **Misconception #4:** “When the deal is done, negotiation stops.” **Reality:** Even after the economic contract is signed and minds have met on the underlying social contract, continuing investment in the ongoing social contract can avoid costly misinterpretations and can greatly enhance the value of the economic contract, especially in addressing new opportunities and unexpected challenges.

- **Misconception #5:** “The social contract is primarily psychological.” **Reality:** Expectations about the nature and duration of the relationship as well as about ongoing process are frequently intertwined with and embodied in the economic contract. The twin contracts generally overlap and should complement each other.

- **Misconception #6:** “The social and economic contracts are static.” **Reality:** While many people treat the twin contracts as cast in cement, they should be negotiated and viewed in a way that is open to evolution and that anticipates vulnerabilities along with predictable changes in circumstances and attitudes.

In short, the right minds should meet on the underlying and ongoing social contracts. The social contracts should be productively dovetailed with the economic one in a way that constructively embraces change. Carefully negotiating both the letter and spirit of the deal offers the highest promise of realizing the full potential of the situation.

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1 Copyright © 2002 by Ron S. Fortgang, David A. Lax, and James K. Sebenius. Special thanks to Ashish Nanda, who provided invaluable insights and examples, as well as to Michael Yoshino, Deborah Kolb and members of the Harvard Negotiation Roundtable.


“Torch that sent a deal down in flames,” Financial Times, Wednesday, April 12, 2000, p. 22.

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The example in this paragraph is taken from Denise Rousseau, p. 12

These insights parallel observations made by Rousseau in terms of how employees view breaches of psychological contracts with their employers, p. 112-127.

An extensive description of these events can be found in the four-part Harvard Business School case series by Ashish Nanda, Ron Fortgang, and James K. Sebenius, “Honda-Rover (A), (B), (C), and (D),” Boston: Harvard Business School Publishing case numbers 899-223, 899-224, 899-225, and 899-226 (1999).


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Dyer and Singh’s (1998) excellent survey cites and evaluates a large number of studies that support the claims made in this paragraph.


“BMW Loses Patience with Sluggish Rover,” Time Newspapers Limited, August 11, 1996.

31 The contracts did have termination provisions in the event of a change of control, but given Honda’s investment and economic profit from the ongoing relationship, these provisions were not credible threats to block a deal.


35 An elaboration of the view that “relational” contracts should be thought of as complements rather than substitutes for legal contracts can be found in Laura Poppo and Todd Zenger, “Substitutes or Complements: Exploring the Relationship Between Formal Contracts and Relational Governance,” Unpublished manuscript, Virginia Tech and Washington University, 2001.


38 Business Week, p. 108; Yoshino and Rangan, pp. 32 and 48-58; and communication with Ashish Nanda.


40 We are grateful to Ashish Nanda for this example.


42 This example was suggested by our HBS colleague, Myra Hart.