



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

Negotiating the Spirit of the Deal

by Ron S. Fortgang, David A. Lax, and
James K. Sebenius

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Negotiating the Spirit of the Deal

The Idea in Brief

The deal looked so promising: a merger of Deutsche Bank and Dresdner, which would have produced the world's third largest bank. But the agreement unraveled within hours of its announcement.

What happened? While the parties had agreed to the *letter* of the deal—the economic contract—they neglected its *spirit*—the **social contract**—which included assumptions that the new entity wouldn't sell a Dresdner division.

Though parties may agree to identical terms on paper, they may have contrasting expectations about how their agreement will work *in practice*. Unless they concur on the social contract—that is, by explicitly discussing assumptions *before* cementing a deal—the agreement may sour.

The Idea in Practice

THE SOCIAL CONTRACT

The social contract has two levels:

- **The underlying social contract** answers, *What* is our agreement's nature and purpose? Is this a short- or long-term deal? A discrete transaction or partnership? How much autonomy will each party have? What decisions will each participate in? Parties differing in basic ways—small versus large, entrepreneurial versus bureaucratic, and so on—often hold divergent views of the underlying social contract.
- **The ongoing social contract** answers, *How* will we work together? How will we communicate? Consult with each other? Resolve disputes? Handle surprises?

RISK FACTORS

Lack of awareness causes most social-contract misunderstandings. Parties form expectations about how the deal will be implemented but don't necessarily discuss them. Certain conditions are especially ripe for misunderstandings:

- **Cultures clash.** When a U.S. plant manager instigated downsizing at NCR Japan, differing cultural expectations about lifetime employment sparked organization of a union and a supplier boycott at NCR Japan.
- **Third parties drive the deal.** When investment bankers or other professional negotiators drive deals, conflicting social-contract assumptions can be overlooked. Involve those who must make the deal work in the negotiating process—where they can begin forging a positive social contract.

► Example:

When Matsushita Electric considered acquiring MCA (owner of movie studios and record companies), former talent agent Michael Ovitz brokered the deal. To build momentum, Ovitz *separated* the parties during negotiation—unwittingly causing each side to form distorted views of the other's intentions. Result? Post-deal friction and Matsushita's sale of MCA to Seagram several years later—at a \$1.64 billion loss.

- **Too few parties are involved in the deal.** Even tightly aligned social and economic contracts can fragment if only a few individuals share the agreement's expectations. Widen the web of dependencies throughout your company to cultivate more sustainable relationships—and greater commitment to implementing agreements.

DOVETAILING THE CONTRACTS

To boost your deal's chances of success, make economic and social contracts mutually reinforcing.

► Example:

To save its business in the late 1980s, Chrysler defined a new *social* contract emphasizing cooperation and long-term partnerships with suppliers, expecting them to improve their own performance *and* enhance Chrysler's overall operations. It also revised its *economic* contracts. Rather than selecting lowest bidders, it prequalified suppliers based on their engineering and manufacturing capabilities and past performance, then lengthened contract life from two to four years. The payoff? A 32% reduction in vehicle-development time and rise in per-vehicle profit from \$250 to \$2,110.

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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 maxi-

mize 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

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The most common causes of social contract problems are lack of awareness and benign neglect.

would have produced the third-largest bank in the world (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 espe-

cially 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 managed 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 openended 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 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 silently shift in response to actions taken, even though no overt negotiation takes place. Of course, if costly misunderstandings are to be avoided, it’s normally in the parties’ best interests to make their expectations explicit and negotiable. And red flags should go up when especially challenging conditions, such as the following, are present:

When Cultures Clash. Negotiators from diverse organizational, professional, or national cultures often bring clashing assumptions to the table. As Ming-Jer Chen, the former director of Wharton’s Global Chinese Business Initiative, explains in *Inside Chinese Business*, “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.” That approach often frustrates businesspeople who assume a signed contract is a done deal and a complete, fixed description of each side’s obligations.

Consider how cultural expectations damaged relationships at NCR Japan. While the

company was U.S. owned, it had a history of stable lifetime employment and a union that enjoyed close relations with management. However, when the plant's first U.S. manager instigated downsizing to enhance returns—even though the plant was profitable—employees resisted this perceived violation of the underlying social contract. A second union was quickly organized, and it took a far more adversarial approach, demanding higher wages and insisting on job guarantees. Local suppliers saw the company as untrustworthy and refused to do business with it. A full decade after the plant manager was ousted, the second union remained in power, and the supplier boycott continued.

This example underscores not only the risk of underestimating differences between cultures but also the strength of the backlash to perceived breaches of a social contract. It's important to note here that not all breaches need

be fatal; how they are handled can strengthen or rupture the social contract. If a breach is inadvertent, for example, managers normally should acknowledge it and reassure the other side that the “violation” was unintentional, not exploitative. Indeed, sincere efforts to rebuild confidence can often buttress the existing social contract.

When the Wrong Minds Meet. Sometimes problems arise not because of cultural differences but instead because the right people are not involved in negotiations. For example, when two CEOs negotiate a strategic partnership—say between a retailer and a supplier—they may stress the importance of many dimensions of cooperation, the mutual need for service and quality, and the long-term time horizon of the joint effort. Yet the retail buyer, for instance—mainly compensated on the basis of quarterly numbers—refers to “our strategic partnership” primarily to beat price

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?

Ongoing Social Contract

Consultation

How fully, formally, and frequently do you expect to consult with the other side? How extensively will you and your partner share or protect information?

Decision making

Beyond the formal governance mechanisms, by what process do you want to discuss and make decisions: by consensus or majority? Informally or formally? Who will be involved?

Dispute resolution

In the case of conflict, what approach do you expect to use: informal discussion, mediation, binding arbitration, court? What if disagreement persists?

Reevaluation and renegotiation

How will you handle unexpected challenges (such as changing economics or competitive dynamics)? What should trigger reevaluation or renegotiation, and what should you and your partner expect from each other in such a case?

Meeting of the Minds and Fit

Alignment

Do the economic and social contracts reinforce each other? If they don't, what should you and your partner do to align them?

Shared perceptions

All things considered, what's your view of the social and economic contracts? What do others in your organization think? What is the other side's view, and does it mesh with yours? How do you know? How can you and your partner ensure that you have a real meeting of the minds on your perceptions? If you discover divergent perceptions, how should you resolve them?

Different parties can hold wildly divergent expectations about the deal, even when they've signed the same piece of paper.

reductions out of the supplier. This problem will persist unless senior retail executives work to reset employees' expectations and incentives at the working level when they forge what *they* see as a strategic alliance.

There are other, less obvious, ways that key parties are inadvertently omitted from social contract negotiations. For example, in 1988, Komatsu, Japan's leader in earth-moving construction equipment, and U.S. conglomerate Dresser Industries combined their North American engineering, manufacturing, and marketing efforts to attain what they called a "mountain of treasure." Dresser sought Komatsu's design technology and a cash infusion for plant modernization and capital expenditures. Komatsu hoped to become a successful global player, so it wanted better North American market penetration. While preserving parallel brands and distributorships, Komatsu and Dresser created a 50-50 joint venture (Komatsu Dresser Corporation, or KDC), merging manufacturing, engineering, and finance operations. The joint venture maintained equal management representation on the six-person oversight committee and agreed to a \$200 million investment. Beyond the economic terms of the companies' arrangement, they aimed to foster a strong social contract between their management teams.

Yet the implementation of their arrangement strained the emerging deal, and the separate distributors, who never subscribed to the new expectations, began competing for sales. Tensions escalated: Komatsu saw Dresser as backward and unresponsive; Dresser complained of learning about key Komatsu decisions after the fact. As the situation worsened, executives from both companies clamped down on communications, which prevented dealers from getting vital information about their counterpart's inventory levels and warranty coverage, further exacerbating the conflict.

Despite the efforts of industrial consultants and a last-minute plan to swap employees between the two companies, the dealer conflicts intensified, KDC market share declined sharply, losses mounted, 2,000 jobs were cut, and ultimately, the venture was dissolved. Subject to more than the usual cross-cultural hazards, KDC suffered: It failed to ensure that potentially influential parties bought into the new social contract.

When Third Parties Drive the Deal. Failure also happens when one team, such as the business development unit, uses a heavily price-driven process to negotiate an alliance or acquisition. Once the parties agree to the terms, the team "throws it over the fence" to operational management, which is stuck with the unenviable job of forging a strong, positive social contract after the fact. Jerry Kaplan, Go Technologies' founder, was especially critical of the negotiation process IBM used when it invested in Go. As Kaplan explains in *Startup*, "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." With a process like that, the right minds have little chance of truly meeting on the underlying social contract. It's almost always best to get the managers who must make the deal work involved in the negotiating process, where they can begin to forge a positive social contract.

In some cases, investment bankers or other deal makers with a powerful interest in making a transaction happen—for better or worse—can divert the principals' attention from possibly fatal differences in their views of the underlying social contract. For example, Matsushita Electric's primary rationale for paying \$6.59 billion for MCA—owner of movie studios, record companies, and theme parks—was to ensure a steady flow of creative software for its global hardware businesses. Senior MCA management agreed to the acquisition, expecting the new, cash-rich Japanese parent to provide capital for acquiring more record companies, a television network, and so on, all of which were vital to helping the combined companies compete with rivals such as Disney and Cap Cities/ABC.

To get the deal done, however, Michael Ovitz, talent agent turned unorthodox corporate matchmaker, kept the parties mostly *apart* during the process, managing expectations separately on each side and building momentum until the deal was virtually closed. Neither side did its due diligence on their mutual perceptions of the real underlying social contract—partly because of the cultural chasms dividing old-line industrial Japan, creative Hollywood, and the New York financial community, but largely due to the deal-driving third party (Ovitz). As a result, each side had

an optimistic but badly distorted view of the other's real intentions, leading to postdeal friction and the sale of MCA a few years later to Seagram, at a substantial loss to Matsushita both in financial terms (roughly \$1.64 billion) and in prestige.

When Too Few Parties Are Involved in the Deal. Even a tightly aligned social and economic contract can be vulnerable if the expectations and agreements that underlie it are shared by only a select few. Senior partners in consulting firms, for instance, often depend primarily on their relationships with CEOs in their client companies. But if the CEO leaves, the consulting firm may lose the account. Consciously creating a wider web of involvements and dependencies throughout the firm would result in a more sustainable relationship—and greater commitment to implementation of agreed-upon recommendations—even when fewer participants could complete the consulting projects more efficiently.

Dovetailing the 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 one. Sometimes, the way to arrange such a fit seems obvious: A discrete, project-oriented agreement, for instance, should have clean, workable exit and termination provisions linked to both sides' understanding of when their shared objective is accomplished (or has become impossible). By contrast, if a deal's central aim is ongoing knowledge transfer, negotiators might set terms in the economic contract that would further that goal. For instance, when Wal-Mart and Procter & Gamble formed an alliance, interface team members signed confidentiality agreements, binding them from releasing information from team discussions even to their own parent companies. This cemented the group's commitment to total discretion and unleashed greater creativity, since members could try things out without fear that proprietary data would be shared outside the alliance team. Whatever the goal of the deal, it will generally be much easier to reach if the economic and social contracts are mutually reinforcing.

Some companies have mastered this skill.

Italian apparel-maker Benetton, for example, has enjoyed many successes in new markets by following a tried-and-true formula. First, it establishes a local agent to develop licensees for products from Italy; then it develops local production capability, partnering with an area business for further market development. If that is successful, it buys out its partner, which typically retains a significant role, and integrates the foreign subsidiary into Benetton's global network. This staged approach has worked repeatedly because Benetton's contracts with its local partners explicitly detail the expected trajectory of the partnership and include formal mechanisms to accomplish its stated goal.

Many companies bungle the kind of smooth transitions Benetton often achieves because they fail to fully vet expectations about how their partnerships will run. If negotiations are handled poorly, high-status local partners can end up feeling betrayed and devalued by unexpected buyout initiatives. In addition, badly handled negotiations can result in unworkable valuation formulas that lead to disagreements, impasses, and the like. No successful private equity or venture capital firm would invest without establishing clear exit expectations for when milestones have been met or when circumstances have changed. Despite the potential awkwardness of negotiating a prenuptial agreement while heading into marriage, most companies should spell out similar provisions in their contracts.

To highlight how critical it is to dovetail the letter and spirit of a deal, we like to contrast two cases, negotiated by different experienced investors during the same year, in which subsequent attitudes toward the deal played key roles. The first involved prominent pediatricians who were looking for assistance to make a series of interactive CDs on parenting issues. A venture investor provided capital in return for a half-interest in the new company that would own all the doctors' products in this business area. The investor helped the doctors create a demo CD, wrote a business plan and marketing materials, and showed the entire package to key people at major software publishing houses. When a publisher 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 willingly re-

duce his stake. Needless to say, after all the time and effort he had invested in developing the company, he felt stung. When efforts at resolution reached an impasse, the new company languished, and the agreement blocked the doctors from developing their ideas elsewhere. Clearly, both sides neglected to 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. As a result, great value was left unrealized.

By contrast, consider the contract a different investor designed when he was approached by a commercial banker who financed independent filmmakers. Although filmmaking is a risky business, the banker had not lost money on any of his 41 loans—in part because he had nurtured worldwide contacts and then presold foreign rights. Unhappy with his compensation as a bank employee, he was planning to leave and start a film-finance company. To get the fledgling business off the ground, he was seeking an \$18 million investment to complement the \$2 million he would contribute, and he offered the investor 90% of the new company.

Even though the investor's analysis projected a 100% annual rate of return on this investment, he turned down the offer and counterproposed a deal that was, in fact, 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-entrepreneur would end up seeking a better deal from new capital sources. Therefore, his counteroffer contained a series of results-linked options: The banker would be able to buy back some of the investor's equity at a relatively low price after the investor had received his first \$5 million, then buy back more 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 rather than to start out on his own again. The investor's projected rate of return on this offer was closer to 30%. But he preferred to sign a contract stipulating a 30% return that he believed he would actually receive rather than one with a 100% return on paper that would very likely spur the banker to abrogate at some point.

This investor understood that the spirit and letter of the deal needed to complement each other, whereas the investor who financed the doctors' CD development company struck an economically sensible but perhaps psychologically naive deal. The investor involved in the film-finance company structured his proposal to match predictable changes in circumstances and attitudes, and he found the right fit between the economic and social contracts.

Not only should the social contract complement the economic one, but the economic contract itself can also actually embody much of the social one. In the late 1980s, for example, Chrysler deliberately restructured both the letter and spirit of its contracts with suppliers to save its business. In 1989, the company faced a projected \$1 billion overrun on a new program, a \$4.5 billion unfunded pension liability, and a record loss of \$664 million in the fourth quarter. To stop the hemorrhage, Chrysler decided to revolutionize its supplier relationships (along with other strategic measures). The automotive giant had traditionally given its business to the qualified bidder offering the lowest price, relying on supplier competition to drive down costs. Now it looked to form long-term partnerships with a subset of its traditional suppliers. In this new model, the partner was expected not only to improve its own performance but also to enhance Chrysler's operations beyond the supply relationship.

To support this new social contract, Chrysler substantially revised its economic contract. Rather than choosing the lowest price from qualified bidders, Chrysler prequalified a group of suppliers (1,140 out of its original 2,500) based on their advanced engineering and manufacturing capabilities and on their past performance in terms of on-time delivery and the like. Within this 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.

Under the old system, the average supplier contract lasted 2.1 years. The new approach saw the life of an average contract grow to 4.4 years, and Chrysler gave oral guarantees to more than 90% of its suppliers that the current

business would remain with them for at least the life of the relevant model if performance targets were met. Because this new social contract stressed cooperation, Chrysler sought to ensure a fair profit for all parties. Instead of relying on commodity pricing to squeeze its suppliers, the automaker adopted a target-costing approach that worked backward from total cost to end user in order to calculate allowable costs for systems, subsystems, and components. Further, in keeping with the spirit of cooperation, Chrysler required suppliers to look beyond their own operations and find cost-saving possibilities within Chrysler itself equal to at least 5% of contract value—and suppliers would get half of the savings.

In essence, the written terms of the new economic contract—on selection, scope, duration, renewal, pricing, and performance requirements—consciously underpinned the new social contract emphasizing longer-term, integrated partnerships. The results were impressive: Chrysler was able to cut the time needed to develop a vehicle from an average of 234 weeks during the 1980s to 160 weeks in 1997—a 32% reduction. The cost of developing a vehicle plunged between 20% and 40% during the 1990s, and profit per vehicle jumped from an average of \$250 during the late 1980s to a record of \$2,110 in 1994. A new social contract deeply intertwined with the new economic one was largely responsible for these results.

Clearly, Chrysler saw dramatic improvements, but this particular social-economic contract combination isn't right for every company. Forging tight partnerships with a much smaller supplier base has some drawbacks. These include the difficulty of further shrinking the supplier base as relationships deepen as well as the risk of being "held up" by a critical supplier that has no real competition, especially in a tough economy. The crucial point, however, is that the underlying and ongoing social contracts consist of more than purely "psychological" expectations; they can and should be embedded in and complemented by the formal economic contract.

Common Misperceptions

We have witnessed dozens of deals unravel or fall well short of their potential because the participants failed to achieve a meeting of the minds on the spirit of the deal. To avoid that

fate, make sure you don't fall prey to the following misperceptions:


Many people believe that the social contract is primarily about the working relationship. But as we've shown, the social contract defines not just how the relationship will proceed but also exactly what the real nature of the relationship is. So while the ongoing social contract covers the working relationship—including expectations about communication, consultation, decision making, dispute resolution, and opportunities for renegotiation—the underlying social contract outlines expectations about the fundamental purpose, extent, and duration of the deal.

Another popular misconception is that the term "social contract" means a cooperative, democratic, and participatory relationship. The social contract can embody those ideals, but it need not. Indeed, a productive social contract could detail an autocratic relationship or an "eat what you kill" culture. What's key is that both parties move toward shared expectations about the deal.

Many people think that a social contract implies that the parties involved have a shared view. As we've shown, different parties can hold wildly divergent expectations about the deal, even when they've signed the same piece of paper. Reaching a shared understanding is crucial, but getting to that point takes focus and energy. A healthy social contract, mutually understood, is a goal, not a given.

Too many people set themselves up for failure because they think negotiation stops when the ink dries. However, even after the economic contract has been signed and minds have met on the underlying social contract, the parties should consider adapting the agreement to changed circumstances. And, by continuing to invest in the ongoing social contract, the people involved can help avoid costly misinterpretations and can greatly enhance the value of the economic contract, especially when they want to explore new opportunities or must tackle unexpected challenges.

A final misperception, and one that bears repeating, is that the social contract must be primarily psychological, or "soft"—not something that can be spelled out in a written agreement. But as we've shown, key provisions of the social contract—such as expectations about the nature and duration of the relationship—can often be made explicit in the eco-

conomic contract. Negotiating complementary economic and social contracts greatly improves the odds that the deal will deliver the benefits it promises on paper. 

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1. Sources for such studies, along with a more complete set of sources for this article, can be downloaded from http://www.people.hbs.edu/jsebenius/hbr/negotiating_the_spirit_of_the_deal_v3-41b.pdf.

2. "Torch That Sent a Deal Down in Flames," *Financial Times*, April 12, 2000.

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Negotiating the Spirit of the Deal

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