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Accelerating business-to-business contract negotiations: Moving from one-sided to balanced standard contract terms

Hal Bretan and Henrik Lando

Abstract

Many businesses adopt one-sided boilerplate contract terms and conditions that lead to protracted negotiations. Often, the parties ultimately reach a compromise that could have been reached sooner if they had put forward more balanced contract terms at the outset. We ask why this seemingly irrational behavior persists and suggest a different approach. A dominant theory suggests that putting forward balanced terms may be seen as a sign of a weak bargaining position. We argue, however, that agency conflicts and cognitive biases often better explain such behavior. Moreover, we advocate a *speed-to-contract* strategy where the parties elect to use more balanced (value-maximizing) terms from the outset, and thereby avoid costly negotiations as well as delays in realizing the benefits of a transaction.

Introduction

In many branches of industry, a common contract negotiation strategy is for businesses to put forward one-sided boilerplate terms, i.e. standard terms that concerns other aspects of a transaction than the price or the goods or services to be delivered. These may involve, for example, indemnifications, warranties, liabilities for breach, exclusions from liability, payment terms, rights to change certain clauses of the contract at will, choice of law and of forum, and cancellation charges. As a matter of common experience, as neither party readily accepts the other's template terms, what follow are lengthy and costly negotiations that frequently cause a delay for products and services to reach the customer. It is for instance not unheard of for some global Master Services Agreements in the telecommunications industry to take up to six months or longer to negotiate, and a significant part of that time tends to be spent on "boilerplate" terms rather than on establishing a mutual understanding of the key commercial/technical/business drivers and factors that are important for the commercial success of the contract. Often, contract terms end up being more or less balanced, due to the equal bargaining power of the two parties, and much time could have been saved if the parties had initially put forward terms closer to the more balanced outcome. In this article we attempt to explain this seemingly irrational state of affairs and suggest ways in which contracting parties can achieve lower negotiation costs and less delay.

Our argument is divided into three parts.

In the first part, we discuss reasons why costly negotiations and delay may occur even when both parties are fully rational. We argue that this scenario requires at least one party to be uninformed about the other's bargaining position or bargaining strategy; this asymmetry of information may make it desirable for the parties to appear to have a strong rather than a weak bargaining position. According to this explanation, protracted negotiations may occur when the parties are afraid to make concessions that may be taken as a sign of a weak bargaining position. We demonstrate in a stylized model how two rational parties can end up in a mutually inefficient situation if concessions are construed by the other party as a sign of weakness.

In the second part of our argument, we question this explanation. From our model, it is clear that if negotiation costs were sufficiently high, and the benefits from one-sided terms sufficiently low, the parties would put forward balanced contract terms at the outset of negotiations. We argue that these two conditions are indeed met in reality, which leads us to look for alternative explanations of protracted negotiations. We suggest that misconceptions of the costs of protracted negotiations and of the benefits of one-sided terms, as well as agency conflicts (where, for instance, lawyers may prefer terms for which they cannot be criticized but that are not in the interest of their clients) are more realistic explanations. Our suggestion is that if both parties knew the real costs and benefits, the equilibrium would often not be for both to seek one-sided terms.

In the third part of our argument we thus point to such commitment strategies. For instance, the parties may commit to a set of balanced principles before entering into negotiations. We recommend that parties, as part of a commitment strategy, adopt a speed-to-contract approach that achieves a balanced and value-maximizing set of risks and rewards, and we describe the main elements of this approach.

We begin with the first part of our argument and now seek to understand both why parties put forward one-sided contract terms and why there is delay. In doing so, we will be drawing on the literature on negotiations, which we will now briefly summarize.

[A brief overview of the literature of costly negotiations](#)

That negotiations can be costly – that such transaction costs exist – is a key element in Coase's writings, including his work on the theory of the firm Coase (1937) and is also part of Williamson's work (as in Williamson (2008)). Bargaining theory has analyzed the following game: Two parties, S and B, for seller and buyer, bargain over \$100; each receives zero if no agreement is reached and in every period one party makes an offer that the other can either accept or reject. Thus, S begins by offering a division of the \$100, B then either accepts or rejects, and if B rejects, B must offer a new division that S must then either accept or reject, and so on. This process runs indefinitely, there is no fixed deadline. Both parties suffer a cost with every passing period as they each prefer to obtain a given pay-off in one period rather than in the next.

Concretely, if S obtains \$1 in period two, this corresponds to achieving δ_S in period 1, where δ_S is an amount smaller than 1 and greater than zero. Similarly for B. S hence discounts her pay-offs by δ_S and B discounts his pay-offs by δ_B , which means that both parties are better off if they reach an early compromise. For example, if S rejects an offer of \$x in period t, it must be because she expects to get at least x/δ_S in period t + 1 (or an even higher pay-off in some period further into the future).

The question analyzed is how fully rational parties will act under these assumptions. It turns out that there is a unique answer to this question if one assumes that the parties act rationally at all stages of this game (an assumption referred to as subgame perfection). This was discovered by Rubinstein (1982). The parties will reach agreement immediately by A offering a split that provides A with $(1 - \delta_B)/(1 - \delta_S\delta_B)$. That is, the pie will be split depending on who makes the first offer and on who is more patient.

This result is of interest in our context for we began exactly from the question of why the parties do not reach agreement immediately rather than go through extended negotiation periods at a cost to both of them. Rubinstein's analysis reinforces this question because in his model it is clearly not an equilibrium to postpone settlement, which can be seen as follows: Imagine an outcome where the parties after some time reach a given outcome such as S obtaining the pay-off 50 (after discounting) and B obtaining the pay-off 40. Then it would have been better for one party to have offered the same division sooner, in which case both could have obtained a better outcome due to less discounting. It is this logic which leads to the result that the parties will reach settlement immediately.

In Rubinstein's model the parties do not bargain over contract terms explicitly but simply share \$100. If we translate it to the setting of bargaining over contract terms we have to make a distinction between those situations where the parties have already agreed on the price and those where the price term remains part of the bargaining. If the price has not been agreed, the theory would predict that the first offeror would suggest value maximizing contract terms (terms that maximize the sum of the parties' valuation of the contract) and a price term reflecting the relative bargaining strength given by the formula above. There would be no reason for the offeror to put forward one-sided terms, as this diminishes the total size of the pie, and hence also the part that it can claim. If, on the other hand, the price has already been agreed, the first offeror can only obtain a larger part of the pie by granting itself better terms; hence some terms will not be value maximizing.

We note that the model provides an explanation for why we observe one-sided terms in reality. According to the model, such terms can arise when the parties have fixed the price before negotiating the other contract terms. On the other hand, the model cannot explain delay, as it predicts instantaneous settlement.

This inability to explain prolonged negotiations suggests that the model is missing some aspect of reality. We now consider possible alterations of the model that might explain not only one-sided terms but also delay.

One possibility is that the model overlooks the fact that the parties may not know each other's bargaining power. Rubinstein's model is based on the assumption that the parties know each other's characteristics, including each other's discount factor (patience). However, if this assumption is dropped, there may be reason to expect delay, for the following reason: If S does not know B's bargaining strength (summarized in the patience parameter δ_B), B may try to appear strong by rejecting offers, and S may try to find out about B's real strength by initially offering B low amounts. If B is actually weak in the sense that delay is costly to B, B may find it advantageous to accept a low offer rather than suffer the costs of a delay. However, B will also know that B can send a signal of strength by rejecting offers. Hence, it is natural to expect, and game theorists have proven, that negotiations can for these reasons drag out. This theory has been well elucidated in Kennan and Wilson (Kennan and Wilson 1990) and has found some experimental support, in Sullivan (2016). It may be added that each party may be uninformed about many factors that determine the other party's bargaining strategy, not only the discount factor. For instance, one party may not know the extent to which the other prefers a fair outcome and dislikes being bullied.

Again, the theory of signaling as an explanation of delay has been developed in the context of two bargainers sharing a sum of money, not in the context of bargaining over contract terms. To translate into our setting, we again have to distinguish between situations where the price has already been agreed and where it is part of the bargaining. In the former situation, we would expect the parties to put forward one-sided terms, but when the price is not fixed, we do not see any reason why the parties would signal *bargaining strength* through one-sided terms rather than through the price term. However, the parties may signal their costs and benefits of particular contract terms and this may lead to one-sided proposals, and to delay.

Another explanation of delay analyzed in the literature involves reputational bargaining. There may be some bargainers who act irrationally by simply claiming a large part of the pie and hoping for the other to give in rather than suffer the consequences of prolonged delay. If there is even a small fraction of such bargainers, it may be a worthwhile strategy to pretend to be one of them, in order to scare the other into submission. If the other, however, does not give in, there will be delay. This has been modeled by Abreu and Gul (Abreu and Gul 2000).

Yet another explanation why parties start off demanding one-sided terms is that there may be an advantage of making high initial demands in negotiations. Experiments have shown a tendency for parties making high initial demands to obtain a larger share in bargaining. As discussed by Weingart et al. (1990), a high initial demand may act as an anchor (Kahneman et al. (1974)) during negotiations, influencing the other party's perception of what is achievable. Experiments suggest that parties do realize that the other's claim is exaggerated but they sometimes still fail

to adjust fully to this realization. However, a high initial demand may also be seen as part of a distributive rather than integrative negotiation tactic,¹ and may thereby through a reciprocal response lead to impasse or delay Weingart et al (Weingart et al. 1990). Due to these countervailing effects, authors disagree about the advisability of making high initial offers. Weingart et al. state (Weingart et al. 1990):

'some researchers suggest that high initial offers should be made while others suggest that an opening offer which is too high can hinder subsequent outcome.'

Of course, if many believe that a high initial offer can anchor beliefs, this can explain delay in bargaining. When the price has been agreed when bargaining starts, a high initial offer will consist in unbalanced non-price terms, while when the price has not been fixed, the parties would rationally signal their type through the price term. Therefore, the theory can better explain one-sided terms when the price has been fixed at the outset of bargaining.

Finally, we would suggest a simple explanation of one-sided initial terms that we have not seen analyzed in the literature. In bargaining experiments, such as those conducted by Murnighan et al. (Murnighan et al. 1999), the parties link concessions; one party offers to concede one contract term if the other is willing to concede another. Making such trades is the point of integrative negotiations. However, quite simply, if one party has already conceded some terms, he or she will have less terms to concede, less bargaining chips, as it were. This explanation may rely on less than full rationality but it strikes us as a potential explanation worth further investigation.

We now incorporate some of the ideas just mentioned, in particular the signaling idea, into a simple model that suggests when it is advisable to put forward one-sided terms. Our aim is to show that even if one grants the basic assumptions of the signaling theory, it may not follow from the theory that it is rational to put forward one-sided terms at the outset of bargaining.

A simple model of when to put forward one-sided boilerplate terms

Consider the example of negotiations concerning liquidated damages in case of delayed performance. The Seller S may have to pay either L_1 , L_2 , or L_3 in case of delay, where $L_1 < L_2 < L_3$. S prefers the low term, L_1 , while B prefers the high term L_3 . We imagine that the parties' strategies consist of asking for either, L_1, L_2 or L_3 . Naturally, S is tempted to initially ask for L_1 while B is tempted to ask for L_3 . We simplify the gist of the signaling theory by assuming that a party loses bargaining power if it shows weakness, i.e. if it alone does not demand its most preferred term. Hence, if B claims L_3 , which is her preferred term, and S only claims the

¹ A distributive tactic is one that seeks own gain at the expense of the other while an integrative tactic enables mutual gains from trade.

balanced term L_2 , there will be protracted negotiations but B will eventually win, since S has shown weakness. This is a stark interpretation of the signaling model, but we wish to make assumptions that are friendly to the theory in order to show that it may still not hold when confronted with the real costs of delay and with the actual benefits of one-sided terms. On the other hand, if both parties ask for the balanced term, we assume this will be achieved without costly bargaining. Also, if one party asks for the term which the other party prefers, this term will be realized without negotiations. Finally, we assume that if both parties ask for their preferred term, they negotiate and end up with a balanced term. We believe, as mentioned, that the latter assumption reflects what often occurs in reality.

For concreteness, we further assume that a party obtains the pay-off 2 under the balanced term L_2 , and the pay-off -2 under the other's preferred term. The pay-off to the party who obtains its most preferred term is assumed to be 4. What matters is that this number is higher than that for the balanced term, and that it is not so high that the total value of the contract, i.e. the sum of the pay-offs of the two parties, is higher under the unbalanced term (since that would mean that the parties would be advised to seek the unbalanced term; the advantaged party could then compensate the other through an adjustment in the contract price). With the given pay-offs, the sum of pay-offs is 2 under an unbalanced term (L_1 , or L_3), namely $4 - 2$, while it is $2 + 2 = 4$ under the balanced term L_2 . In the following, our results will not depend on these exact numbers; we could have chosen any three numbers x , y and z instead of 4, 2 and -2, for pay-offs under the preferred, the balanced and the non-preferred term, as long as x is greater than y and y is greater than z and $2y$ is greater than $x + z$. Also, we could dispense with symmetry of pay-offs without changing any of our results.

Under these assumptions, which basically accept the logic of the signaling theory, pay-offs are indicated in Table 1 below, where c is the cost of bargaining. In what follows we need not put any restrictions on the size of c , it can be anything. Our point will be that its size determines the parties' optimal strategies.

The seller's strategies are in the first column and the buyer's strategies are in the first row.

To clarify, the strategies are the opening offers; we do not model the negotiation process but assume that outcomes follow from the opening offers in a manner consistent with the signaling theory, i.e. that one loses bargaining strength if one concedes the term in one's opening offer.

Table 1.

Seller\Buyer	L ₁	L ₂	L ₃
L ₁	(4, -2)	(4 - c, -2 - c)	(2 - c, 2 - c)
L ₂	(2, 2)	(2, 2)	(-2 - c, 4 - c)
L ₃	(2, 2)	(2, 2)	(-2, 4)

The seller's pay-off is listed first and the buyer's pay-off is listed second, such that (4, -2) denotes a pay-off of 4 to S and -2 to B. The highest total pay-off, the value maximizing contract is reached at (2,2) where terms are balanced and no bargaining occurs. To exemplify, the pay-offs (4 - c, -2 - c) in the upper row occur when S claims his preferred term L₁ and B concedes by only claiming the balanced term L₂. There will then be negotiations where S will eventually obtain his preferred term, which is why S will obtain 4 - c, while B will obtain -2 - c. Strictly speaking, since B loses in the end, she could give in immediately and hence avoid the cost of negotiations but we have in mind that B must limit the extent to which the term becomes unbalanced, although this aspect is not part of the model.

We consider the Nash-equilibrium which is defined by neither party having an incentive to change strategy given the strategy of the other party. Consider the candidate for such an equilibrium where both choose the balanced, value-maximizing strategy L₂. This is an equilibrium if c is greater than 2, where 2 is the difference between the gain from a one-sided term to the advantaged party and the gain from the balanced term (4 - 2). This can be observed by noting that if S changes to L₁ when B sticks to L₂, S obtains 4 - c, while S obtains 2 by sticking to L₂. If c is smaller than 2, both will put forward their most preferred term and we end in the Nash-equilibrium where S suggests L₁ and B suggests L₃.

To summarize, we can replicate the idea that both parties will put forward one-sided terms, which is an equilibrium in the model in the sense that neither party will act otherwise when the other party acts in this manner. It is worth noting that the equilibrium represents what is referred to in economics as a prisoner's dilemma. This refers to a game theoretic situation where two prisoners will both have an incentive to report on each other to obtain leniency and where both prisoners therefore end up worse off than they would if they could credibly agree not to report the other. In fact, as in this game between prisoners, both parties choose their dominant strategy (the strategy which is best for that party regardless of the strategy chosen by the other party) and they both end up in a worse situation than if both acted cooperatively by putting forward balanced terms at the outset.

If c is greater than 4, there also exist Nash-equilibria where one party concedes fully in order to avoid bargaining (where either S concedes by suggesting the term L₃ or B concedes by suggesting

the term L_1 ; there are the outcomes in the upper left or lower right corner). Hence, the model tells us that there will be delay and one-sided terms when c is smaller than 2, whereas if c is greater than the advantage of one-sided terms ($4 - 2$), delay will be avoided either by both parties suggesting balanced terms or by one of the two parties conceding fully.

From these findings we can conclude that if one accepts the basic ideas of the theory of delay as a result of signaling (or as a result of the possibility of losing bargaining chips by conceding initially), the theory can only explain one-sided terms and delay when the bargaining costs are lower than the advantage of one-sided terms. Or more exactly, delay can be explained when the parties *perceive* the bargaining costs to be lower than the advantage of one-sided terms. What matters in our game above is what parties' perceive the costs and benefits to be. If perceptions change, such that it is realized that the cost of negotiations is higher than the advantage of one-sided terms, the equilibrium will change as well. Our claim is that the parties' perceptions often exaggerate the advantage of one-sided terms while downplaying the more subtle – but often much larger – costs of delays in finalizing contracts. As we will now argue, the costs of prolonged negotiations can be very significant in the context of complex negotiations between large firms, while the benefits of one-sided terms are often illusory.

On the costs of bargaining and the drawbacks of one-sided terms

Prolonged bargaining is costly both directly in terms of its use of scarce resources and indirectly through delay in realizing the benefits of the transaction.

As for the direct costs, it is worth recalling that contract negotiations do not just involve attorneys, but in fact involve personnel across multiple departments. When large organizations negotiate, various departments are involved on either side, including but not limited to Legal, Sales, Procurement, Operations, Product Management, and Bid Management. For example, if the customer demands a term involving harsh liquidated damages for failures to perform aspects of a service, Operations, Finance, Sales, Risk Management and Legal are all involved in assessing the risks vs. rewards of the deal and exploring ways to either mitigate the risk and/or pressuring the customer to back off of its position.

Moreover, the end-user recipients of the goods or services are typically involved either on a part time or a full time basis. Representatives from diverse parts of the companies come in and out of negotiations as issues come to the fore and as key decisions must be made. Although not all departments are involved throughout the negotiations (such as when "legal" terms are being hashed out), it is generally impractical to segregate terms of an agreement by stakeholder, and so subject matter experts (for example, for tax, insurance, import/export) typically are asked to join calls, waiting for their relevant clauses to come up for discussion. This of course diverts scarce resources from other value-added tasks. Moreover, to the extent issues cannot be resolved at the working level – due to their complexity or to limitations on decision-making

authority delegated downward – executive time and effort are also absorbed during the process. For these reasons, global Master Services Agreements can take up to six months or longer to negotiate, and a significant part of that time is spent on “boilerplate” terms rather than on establishing a mutual understanding of the key commercial/technical/business drivers and success factors that underpin the mutual benefits of the parties.

Moreover, transaction times for negotiations are not just the hours spent on calls or in person with the other side. Numerous internal discussions take place in each company as the other party’s red lines are reviewed and considered and negotiating tactics explored and agreed. In cases where exceptions to internal policies have to be made to get the deal done, governance processes and escalations to executives have to take place, adding more cost. The internal consultations can be just as time consuming if not more than the face-to-face negotiations. Much time and resources are spent analyzing the consequences of alternative contract terms, as when internal stakeholders need to decide whether a term proposed by the other side is acceptable. This situation is exacerbated when outside counsel is used. Not only are the hourly rates much higher than internal costs but outside lawyers are not typically empowered to make the more difficult decisions unilaterally, and so yet more cycle times are expended to get appropriate client approvals. Lastly, there are opportunity costs lost when internal resources continue to be focused on closing the current business (which in many respects has already been “won”) and cannot shift their full attention to new transactions that would further benefit their company.

There is little empirical measurement of these costs of contracting. The only measurements we are aware of are due to a study by World Commerce and Contracting (formerly, the International Association of Commercial and Contract Management (IACCM)) (<https://blog.iaccm.com/commitment-matters-tim-cummins-blog/the-cost-of-a-contract>) which, based on analysis of more than 700 major organizations in the US and Europe, found that business spend on reviewing and negotiating a standard, low risk procurement or sales contract in 2018 averaged \$6,900. Costs for a mid-complexity contract with more significant risks and review were \$21,300, while high complexity procurement contracts, with “unique” risk factors averaged \$49,000. For some complex contracts costs ran into hundreds of thousands of dollars. From these numbers it is not clear how much time is spent on boilerplate terms rather than on other terms such as those defining the scope of the agreement, but another finding was that organizations on average spend about 25% of their time on contract creation (including activities such as requirement definition and developing scope), 30% on negotiation and 45% on review and approval. In the most efficient firms, the proportion of time spent on creation increased to more than 40%. While these numbers are suggestive of very real transaction costs, it is clear that more research is needed to document their exact nature.

Awaiting better statistics, we provide the following numbers that are in the experience of one of us indicative of the costs involved in the negotiations of a typical, major global transaction in the telecommunications industry:

- The average number of people on each side of the table during a typical negotiations session: 5.
- The average length of each negotiations session: 1 hour.
- The average length of internal discussions between negotiations sessions: 3 hours with 5-7 participants.
- Number of negotiations sessions: 25 covering multiple documents that make up the contract, not just the boilerplate.
- Time between negotiations sessions – starts off 2 weeks apart and then becomes more frequent as the issues list dwindles.

We stress that these statistics are not based on hard documented evidence but rather on the general experience of one of us. We believe, however, that the numbers are not far off, and while not precise, nevertheless indicative of the size of transaction costs (though not exclusively related to boilerplate terms).

Besides these transaction costs, lengthy negotiations also cause delay that is detrimental to both parties. For sellers, delay in receiving revenues comes at an obvious cost, while for buyers, delays in obtaining goods and services often result in the postponement of cost savings, of technology refreshes, or of expansion plans. To illustrate, consider a supplier of a service that costs \$500.000 per month to deliver and that yields a revenue of \$1M per month. Assume that the buyer pays \$1M per month and gains \$1.2M per month in value from use of the service. If the contract runs for a fixed term of five years, and the rate of interest equals 5%, accelerating the income/value stream for both the seller and the buyer by one month means that the net present value of the contract to both parties increases by a total of \$700.000 times $(1 - (1.05)^{-5}) = \$151.531$. Naturally, if either or both of the parties are singularly focused on near-term benefits, this corresponds to a higher rate of discounting, and hence to an increased benefit from acceleration of the transaction. Further, if the contract can be expected to be renewed after five years and runs into the indefinite future, the value of speed to contract approaches \$700.000. What is more, delay often results in later introduction of innovative products or processes in the marketplace, which can be critical, as many innovations derive their value from the time period in which the innovator has a competitive advantage before others catch up or imitate. For instance, Cohen et al. (2000) showed that lead time was considered by managers the most important means of protecting product innovation in 10 out of 33 industries. In sum, we suggest that c in the model above, the cost of negotiating, is often a very substantial number.

As mentioned, the optimal strategy depends not only on costs but also on the benefits from one-sided terms. We now argue that these benefits are often small and may even be negative in some circumstances. This is so because such terms tend to come with indirect effects that are

detrimental to both parties. We would stress the following, negative, indirect effects of unbalanced terms:

- a) Bespoke, customized products, services, and processes lead to higher costs and greater risks that something will go wrong. Operational groups do best when their actions are repetitive and predictable. When one party must deviate from its normal course of action in order to avoid punitive contractual penalties or to meet bespoke obligations, this often leads to greater expense and more frequent errors, to the detriment of both parties. Typically, as non-standard obligations and processes give rise to errors and failures, the parties must spend additional resources to make things right, putting the profitability of the deal even more at risk for the supplier – while still leaving it with a dissatisfied customer. By contrast, if B as a buyer accepts A’s terms and conditions – which are aligned with how A provides its offerings and with its internal systems and processes – B will benefit from a more predicable, high quality deliverable associated with this alignment.
- b) Pressing for unfair terms may lower competition in the marketplace. A buyer who is known for imposing heavy-handed contracts terms may scare off potential sellers, thereby reducing the number of participants vying for the business. This will add more upward pressure on price. Conversely, when vendors demand unfair terms, potential customers will refuse to seek bids from them.
- c) If a party’s policy of imposing harsh terms becomes known to future trading partners, it is to be expected that they will increase their bids by an amount commensurate with the added risk. If, then, the higher price more than outweighs the benefit of the harsh term to the stronger party, which is what characterizes an inefficiently harsh term, both parties may in the end be worse off than they would have been under more balanced terms. This consideration is especially relevant when the buyer forces the seller to operate in a non-standard manner, as set forth above under (a).
- d) Unfair terms imposed on a party sometimes lead that party to be less interested in cooperating with the party imposing such terms. If, for example, relatively minor faults give rise to liquidated damages that are disproportional to the actual harm to the other party, the party forced to accept that risk will look long and hard at expanding the relationship. Generally, a perception by either party that it got a “raw deal” or one fraught with pitfalls and risks might dampen its long-term commitment to the relationship.
- e) A party who suffers losses over the course of a relationship due to unbalanced terms may feel badly treated, and may reciprocate in various ways, e.g., by not sharing information that it would share in a positive relationship characterized by favors met by counterfavors. Such responses to perceptions of unfairness are well-documented in the

experimental game-theoretic literature (e.g. Fehr et al. (1997)) and are analyzed in a strand of contract theory initiated by Hart and Moore (2008).

- f) When a party suffers what it perceives as unfair losses due to punitive terms, it may lead that party to engage in behavior that is, in a sense, irrational because it risks ruining the relationship. For instance, to recuperate losses suffered due to an unbalanced allocation of risk in the contract, a supplier sometimes demands payment for what it alleges is extra work performed, even though this may lead to a legal dispute if discovered. That party would not ordinarily take the risk of a dispute if it did not feel the necessity of recuperating the losses. Such excessive risk-taking is well-documented in experiments of loss aversion (e.g. in Thaler et al. (1997)). On the sometimes psychological mechanisms through which losses may lead to conflict, see Lando (2020).
- g) The suffering of losses may sometimes incent unethical behavior. There is evidence that a party who has incurred a loss in a contract may be more inclined to misrepresent or lie, e.g. about claims for extra compensation, if the pressure to regain the loss becomes strong enough (Lundquist et al. (2009)).
- h) Onerous contracts often shift focus from the commercial elements of deals to the boilerplate terms, an effect that serves neither party in the long run. The business teams on both sides of the table have spent considerable efforts to get to the point of putting the deal on paper. What should be a time of ensuring that the long-term relationship is accurately reflected in the agreement (typically in schedules, appendices and/or Statements of Work) is dominated by clauses that will have a far less impact over the term but cannot be ignored because of their lopsided nature. The construct of chargeable elements, the definition of deliverables, responsiveness to service issues, and remedies for outages, to name a few, are given less attention than warranted in this scenario. Balanced terms would allow limited resources on both sides to be spent on contract terms that substantially affect the likelihood of effective cooperation.

Hence, the equilibrium of the game presented above may well be for both parties to put forward balanced terms at the outset.

This suggestion naturally raises the question of why the parties have not found this out, i.e., why they have not learned to avoid the costs of lengthy negotiations,

[An alternative explanation of one-sided terms and of delay](#)

We suggest that part of the explanation for why standard terms are often one-sided rests with the overestimation of the benefits of such terms and the difficulty of realizing or documenting their true costs.

As for the overestimation, there are of course real world instances where one-sided terms have been helpful for a party, and such instances are easy to understand and communicate. Stories of such events may easily lead businesses to strive for one-sided terms. By contrast, it is harder to detect the drawbacks of one-sided terms, and harder to measure the costs of lengthy negotiations, delays in reaching the customer, and the costs of ruined relationships. Such costs often go under the radar, in part we believe, because they are hard to document and often misperceived.

We acknowledge that this explanation suffers from the weakness that one might expect learning to take place over time. Businesses that adopt a balanced approach would tend to do better, if our claims above are correct, and one might expect this to become generally known over time.

However, to this objection we would make three further observations.

First, perception of the costs and the benefits is biased, due to the greater salience and observability of the advantages of one-sided terms and due to the difficulty of observing the drawbacks. Therefore learning may be slow or may not occur at all.

Second, learning and change of strategy may be slow or non-existing because of agency conflicts, i.e., the conflicts of interest between the agents in the organization making the decisions and the shareholders. Most significantly, contract terms tend to be the province of lawyers, who often have an incentive to opt for one-sided terms. The legal counsel often has an incentive to avoid risk for which he or she can be blamed. When a loss arises for which the business bears liability or for which the business has not shifted liability to the other party, the question naturally arises why the legal counsel accepted that risk. It may be difficult to explain or document that it was part of an economically optimal risk sharing. Moreover, lengthy negotiations means more demand for lawyer services, particularly when outside counsel is billing by the hour.

Third, incentives aside, some lawyers believe that it is in the interest of the company not to bear any risk; they often do not see or understand the commercial drawbacks of one-sided terms, which is not typically stressed during their schooling or apprenticeships, and which they often do not naturally perceive in their daily practice. More generally, how to treat risk is often misconceived not only by lawyers but also by contract managers or upper management. Assessments of risk should reflect probabilities of events occurring based on historical data and realistic evaluations of future projections; instead, risks are often gauged solely on worst case scenarios. We submit that this worst-case approach to risk sometimes drives strategy with respect to contract terms, and also stands in the way of learning better contracting practices.

The agency explanation suggested above involving either wrong incentives or insufficient understanding, raises the question of why management (if it understands risk appropriately) does not call for a reexamination of contracting practices and for adoption of more balanced terms if these create more value.

We suggest two answers. First, managers may not have sufficient understanding of contract terms to be able to override decisions made by the legal counsel. There is a danger that management, not understanding the legal implication of alternative terms, may unintentionally add risks that outweigh benefits they are trying to achieve. Moreover, overriding lawyers' traditional *modus operandi* may lead to disruptions to ongoing business and internal conflicts and to attorneys exercising less initiative when more is needed. These drawbacks from central intervention are analyzed in e.g. Aghion and Tirole (1997).

Second, management may believe that one-sided terms protect their interests. In fact, they may enjoy their market power and want to capitalize on it without appreciating the longer term implications. It is easier for a CEO to defend how "tough" a company is in the marketplace to a Board of Directors than to demonstrate cost savings and costs avoided by being accommodating and by gratuitously conceding negotiating positions.

As the reader will have noted, we believe that contract strategies can be ill-informed and that learning is not at all instant in the real world. This contention is based on real world observations, of which it may be worth providing an example: A large public buyer was known in the market for incorporating unbalanced terms in its standard form contracts, and had found that it had to pay higher prices than other buyers in the market. When the buyer-CEO met with the CEO of one of its major suppliers to discuss which terms caused the elevated prices, it became clear that some of the terms that the supplier found onerous had been incorporated into the buyer's standard terms as a consequence of unfortunate incidences in the past. For instance, the buyer had at one point ordered a larger volume of a good than desired and was not allowed to return the surplus. As a consequence, a term had been included in the standard form that allowed the buyer to cancel any order, even after delivery, without liability. Naturally, this imposed a significant, uncontrollable risk on the supplier, and eliminating this term benefitted both parties, for the buyer had until then paid a high price for not bearing a risk that had a very low probability of re-occurring as it could be virtually eliminated by the buyer with internal controls. Our experience is that standard contract terms are not rarely shaped in such a manner without proper concern for the economic consequences of burdening trading partners with risk.

To these arguments for why learning to set more balanced standard terms often does not occur, we would add that the optimal negotiation strategy can depend on what others do. If many other firms stick to a strategy of one-sided terms, it may be necessary for a firm to also begin from one-sided terms. In the model, if S chooses L_1 , B will only concede by also choosing L_1 , if c is greater than 4, i.e. twice the difference between the value of one-sided terms over balanced terms. Choosing balanced terms does not then avoid bargaining (as it will be seen as a concession), but still leads to one-sided terms in favor of S (due to our assumption that S will

succeed when B has shown weakness²). There can hence be a risk in unilaterally changing strategy.

The challenge can hence be for parties to commit to balanced terms simultaneously.

The challenge of mutually committing to balanced terms

We have described the possibility of a prisoner's dilemma situation, which calls for the parties to credibly commit to abstaining from one-sided terms: It would be in the interest of both parties to do so, since they would thereby both avoid the negotiation costs. The question hence is whether the parties have a commitment technology at their disposal.

One such technology is agreed documents, which are meant to be balanced terms, reached through negotiations between representatives of both parties. Both parties can adopt such terms contingent on the other doing the same. This changes the logic of the prisoner's dilemma situation; the problem of unilaterally adopting balanced terms is that the other may push for unbalanced terms having observed one's choice. The other party may claim that it is seeking balanced terms but that its costs call for the former party to make concessions. Such a strategy is not possible when the parties make adherence to third party principles contingent of the other's acceptance of those principles. In fact, the choice of agreed terms can become almost automatic in some industries.

Another commitment technology is to adopt vaguer principles formulated by third parties. For example, World Commerce and Contracting has introduced an expanding set of Contracting Principles that, if adopted by both parties to a transaction, are intended to lead to quick resolution of frequently negotiated terms, such as Liability Caps and Exclusions from Liability, SLA Remedies, Indemnification of Third Party Claims, to name just a few. The most current set of Principles can be found at <https://s3.eu-central-1.amazonaws.com/iaccmbrochures/IACCM+Contracting+Principles.pdf>. Additional Principles are being added on an ongoing basis. The Principles have been vetted by members representing a broad range of geographies, industries, and roles, and while they do not prescribe exact contract language, they rather provide a set of contracting constructs that are fair to both buyers and sellers. Those who embrace these guidelines, in whole or in part, are encouraged to reflect them in their contract templates and to live up to them in practice as they negotiate agreements. Note that adherence to the Principles is not legally binding, but what economists refer to as cheap talk: a party could adhere to but then still not adopt a balanced approach. However, as indicated by experiments, cheap talk can in fact serve as a commitment technology, at least to some extent. In experiments, many adhere to promises they have made, due to

² We realize that B will not wish to bargain if bargaining yields her nothing; but our model is here shorthand for the tendency for the outcome to be bad for B when she has shown weakness due to concession.

reputational concerns, internalized social norms, or guilt or lying aversion (see e.g. Dufwenberg and Battigalli (2006), Lundquist et al. (2009), Farrell and Gibbons (1989)).

To summarize, we have argued that prolonged and costly negotiations may not be due to a prisoner's dilemma but may rather be caused by misperceptions concerning the risk-benefit equilibrium, the costs of bargaining and of delay, and/or by agency conflicts. We have also argued that when there is a prisoner's dilemma, as in our model, there may be ways for the parties to commit to a mutually beneficial strategy. We now argue that when there is no prisoner's dilemma, or when it is possible for the parties to commit, the parties are likely to benefit from a speed-to-contract strategy that we now describe.

The Speed to Contract (S2C) approach

Speed to Contract (S2C) is an approach to contracting that focuses on making the process shorter and less costly for both parties. It involves off-the-shelf terms that are already fair and reflective of market norms, and a negotiating strategy that makes negotiations more efficient.

In implementing this strategy, there are tools for identifying which terms are balanced in a given context. Thus, Artificial Intelligence (AI) tools can, to an increasing extent, assist companies in identifying areas where terms are unbalanced. These software analytics can quickly pinpoint market trends for specific clauses, link specific clauses to claims and risks, and review historic documents to predict likely outcomes on negotiations. Going back to the prior example of a term involving punitive, liquidated damages, AI tools that track market norms can show what typical penalties are for failures to meet performance targets in the relevant market segment. Any attempt to impose more stringent penalties will likely meet resistance and result in wasteful negotiations that will in any case ultimately converge towards the market norm (assuming the parties have near equal bargaining power). In terms of our model, AI tools can hence be used to identify which terms are, in fact, balanced and to ascertain the actual costs and benefits of putting forward or resisting one-sided terms. This exercise is particularly valuable when crafting new contract templates or updating older versions in order to keep at the leading edge of the market.

Other resources that can assist in S2C initiatives include insurance industry data on risks specific to particular industries or activities. In addition, industry associations are dedicating more resources in supporting members with templates based on market experiences. Finally, Sales and Procurement organizations can also support the S2C effort by "selling" standard paper – but only after they have been cleansed of unnecessary, one-sided terms.

Part of this strategy is, as indicated above, to evaluate risk on a more objective basis during negotiations. Assessments of risk should reflect probabilities of events occurring based on historical data and realistic evaluations of future projections; it should not be gauged solely on

worst case scenarios. Furthermore, risks should be ranked in terms of their economic impact on business, and it should also be realized that one might be better off mitigating risk instead of attempting to pass the risk over to the other party. This realistic attitude to risk involves a shift of mindset, which must extend to outside counsel and consultants as well so that their focus and actions will be aligned with the new approach.

Finally, as we have emphasized above, the strategy involves ways of committing to it, like adopting principles such as those promulgated by World Commerce and Contracting or by adopting modern contract management processes that embody the role of communication and the continual alignment of expectations.

Concluding summary

Contracting parties often seek to impose unbalanced terms on each other, which leads to costly negotiations involving many stakeholders, and to costly delay. This state of affairs can be thought of as a prisoner's dilemma where either party acts rationally in attempting not to appear weak, but where the outcome is nevertheless bad for both parties. We suggest that this explanation often does not hold as the disadvantages of attempting to impose one-sided terms on a party who has offered balanced terms often appear to outweigh the advantages. For even if a party is successful at imposing one-sided terms, the gains of so doing are often dwarfed by the costs of negotiations, by the delay, and by the indirect negative effects of one-sided terms, e.g., on the spirit of collaboration. Instead, we believe that current practices are, to a significant extent, shaped by misperceptions of the costs and benefits of one-sided terms. One reason for such misperceptions is that while the benefits are salient whenever they occur, some of the costs, such as those involving a deterioration of relationships or the prices set by current or future trading partners, are more subtle and harder to document.

We also suggest that agency conflicts may be part of the explanation for one-sided terms; for instance, lawyers sometimes benefit from such terms or do not think in terms of value creation.

When the situation is not one of prisoner's dilemma, we would expect parties to be willing to adopt a new approach to contracting, speed-to-contract, which emphasizes balanced terms, a realistic and quantitative attitude to risk, and the alignment of commercial expectations.

In doing so, contracts can be transformed from being seen as a necessary evil into a tool for ensuring effective collaboration. Since, however, current strategies may in part be due to agency conflicts and widespread misconceptions, and since the new approach involves a company's willingness to change its overall mindset, it is necessary that upper management become involved in the transition. Executives need to initiate internal discussions on how speed-to-contract can be introduced across their organizations as a key to success in meeting company goals.

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