Ralph Schuhmann
Bert Eichhorn *Editors*

Contractual Management

Managing Through Contracts

Springer Vieweg

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Editors
Ralph Schuhmann
Ernst-Abbe-Hochschule Jena
Jena, Germany

Bert Eichhorn
Contractual Management Institute Berlin
SRH Hochschule Berlin
Berlin, Germany

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Preface

As we often experience in teaching and consulting, law is perceived as something alien in business environments; it is viewed as belonging to the realm of lawyers and is considered to be of no concern to legal laymen unless a case is brought before a court. This notion is due not least to the traditional method of passing on legal knowledge: For non-jurists, it is taught in a 'law light' version, simplified, but retaining juristic aims, modes of thinking, methodology, and language. Law, therefore, doesn't become part of the world of legal laymen. In management and engineering degree programs, we have thus adapted the method of explaining the contract—the most important legal design instrument used in companies—from the point of view of the user, who, in most cases, is not a lawyer. This is also the objective of this book.

Understanding the contract from the perspective of a legal layman has led us to the development of the Contractual Management Approach and, for its instrumentalization, the Contractual Management Model. Part I of this book describes the approach and the model, gives reasons for the need for a paradigm shift in the handling of contracts in enterprises and explains how Contractual Management can bring about such a change. In order to further our objective of improving practical applicability, the book presents a number of case studies in Part II, which aims to demonstrate how the contract works in a business environment and how the Contractual Management Approach can support the manager. These case studies show in particular that in contract deployment, economic, legal, and managerial aspects are inseparably intertwined and require a comprehensive and holistic treatment.

We hope that the Contractual Management Approach will motivate non-jurist readers to understand the contract as an instrument of management which affects every decision-maker and not only the legal department or off-house lawyers. In turn, it may convey to lawyers that the contract is not an end in itself, i.e. a static accord backed up by the threat of legal enforcement to assure a particular behavior of the contractual partner, but instead a management tool embedded in various management processes which simultaneously depend upon and influence these corporate processes.

We are grateful to the authors of the case studies who have taken it upon themselves to implement a new view of the contract, or to show in which respect and to what extent the elements integrated into our model are already applied in practice. Our thanks also go to Frank Wittig who helped us out with language and managed formatting matters, as well as to Silia Kaplan for translating and for making our English sound more English.

If you have any questions or comments, please feel free to contact the editors at Contractual Management Institute, cmi.berlin@srh.de.

Szklarska Poręba
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Ralph Schuhmann
Bert Eichhorn

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Reader's Guide

This publication addresses the usage of contracts in business. It explains contracts not from the perspective of economics, law, or any other scientific discipline, but rather from the point of **view of the user** inside a company, i.e. the manager in sales, procurement, projects etc. who is usually a legal layman. For such a practitioner, the contract is an essential working tool.

In terms of its practical orientation, the book is divided into two parts:

- **Part I offers a new view of the contract and contract handling**. It elaborates on the differences in the understanding and perception of a contract depending on the education and the professional position of the observer. For this, the first three sections summarize the current state of contract handling in both scientific research and practice and highlight the current and future challenges in this field. In Sect. 1.4, the Contractual Management Approach (CM Approach) and the Contractual Management Model (CM Model) are introduced as two comprehensive and holistic concepts for the understanding and usage of contracts in business and discussed with regard to benefits and limitations. But most importantly, these concepts offer a new didactic approach for passing on contract-related knowledge in particular to non-lawyers who do not require profound insights into contract law but concrete skills to handle the contract in practice.
- The 11 **case studies presented in Part II** of this book highlight the deployment of the contract in different practical scenarios. The case studies demonstrate that the core of Contractual Management is made up of four fields of management—risk, knowledge, corporate management, and management of the relationship—which align contract handling with the aims of the enterprise and the latter's external relationships just as much as the contract supports the achievement of such aims. Insofar as these input and output functions are adequately planned and implemented, the contract can take on its role of steering internal and external processes and thus execute its management function. Every case study examines the usefulness of the CM Model for tackling managerial issues and, in particular, considers the intersection of management aspects and legal aspects, which is a prerequisite for the analysis of contractual topics within a company and the development of workable solutions.

This book can be read and used in many ways:

- The editors, of course, suggest a traditional usage **starting with Part I** before turning to the case studies in Part II. This sequence allows the reader to move beyond any previous understanding of the contract and to gain awareness of a new comprehension of contractual interdependencies in companies, which paves the way for a full appreciation of the CM Model's practical benefit when dealing with the managerial issues addressed by the case studies.
- For the practitioner, it might be of more interest to first **read Part II or any of its case studies** in order to immediately gain access to the managerial core issues. However, for the application of the CM Model or the restructuration of a respective corporate process, the theoretical explanations outlined in Part I are indispensable because they enable the reader to expand his or her perspective to the entire topic area of contract handling and to grasp its interdisciplinary challenges. The case studies guide the reader to more deeply engage in a change of perspective with regard to his or her understanding of the contract and the contract's deployment.
- Furthermore, the book outlines how to approach specific contract handling topics with its **Inventory of Contract Knowledge**, which compiles all contract knowledge boxes provided by the case studies and is displayed in the Appendices at the end of the book. The boxes are meant to help the reader trace back certain managerial challenges to the underlying contractual issues, and vice versa. Linking questions of contract law and management, they exemplify how and to what depth knowledge in contract law is necessary for legal laymen to complete their daily work within a company. In this way, the reader can learn, for instance, what a liquidated damages clause is, how it works, and how it can be applied.
- Finally, the **Matrix of Case Studies** displayed in the Appendices enables the reader to approach specific operational conditions of a contract in a need-oriented and individualized fashion. The mapping of the case studies with regard to relevant meta data such as principal management topic, institution (sector, company size), subject of management, CM process step, management field, or contract type teaches the reader about the specific framework conditions for the deployment of a contract and the resulting requirements the manager must meet.

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List of Abbreviations and Acronyms

§	section
ACM	Association for Computing Machinery
AfD	*Alternative für Deutschland* (Alternative for Germany)
AI	Artificial Intelligence
AHP	Analytical Hierarchy Process
AND	Allow Natural Death
ASC (842)	Accounting Standards Codification
ASU	Accounting Standards Update
AVB	*Allgemeine Vertragsbedingungen, Behandlungsverträge und Wahlleistungsvereinbarung für Krankenhäuser* (General Terms and Conditions, Treatment Contracts and Optional Physician/Accommodation Agreement for Hospitals)
Az.	*Aktenzeichen* (case number)
B2B	Business-to-Business
B2C	Business-to-Consumer
B2G	Business-to-Government
BÄO	*Bundesärzteordnung* (German Federal Medical Practitioner's Act)
BC	*Zeitschrift für Bilanzierung, Rechnungswesen und Controlling*
BDSG	*Bundesdatenschutzgesetz* (German Federal Data Protection Act)
BetrVG	*Betriebsverfassungsgesetz* (German Works Constitution Act)
BilMoG	*Bilanzrechtsmodernisierungsgesetz* (German Accounting Law Reform Act)
BGH	*Bundesgerichtshof* (German Federal Court)
BGHZ	*Bundesgerichtshof Zivilsachen* (Civil Case Anthology of the German Federal Court)
BMF	*Bundesministerium für Finanzen* (German Federal Ministry of Finance)
BMV-Ä	*Bundesmantelvertrag -Ärzte* (German Federal Framework Contract for Physicians)
BPflV	*Bundespflegeverordnung* (German Federal Hospital Rate Ordinance)
BPMN	Business Process Modeling Notation
BSG	*Bundessozialgericht* (German Federal Social Court)

BSGE	*Bundessozialgericht Entscheidungen* (Verdicts of the German Federal Social Court)
BStBl	*Bundessteuerblatt*
CA	Cancer
CDU	*Christlich Demokratische Union* (Christian Democratic Union)
CEO	Chief Executive Officer
cf.	confer
CIO	Chief Information Officer
CLInt	Construction Law International
CM	Contractual Management
CMM	Contractual Management Model
CM Model	Contractual Management Model
COSO	Committee of Sponsoring Organizations of the Treadway Commission
CRC	Corporate, Risk and Compliance Management
CRM	Customer Relationship Management
CRS	Congressional Research Service
CSM	Construction Site Management
CSU	*Christlich Soziale Union* (Christian Social Union)
CTO	Chief Technical/Technological Officer
DIN	*Deutsches Institut für Normung* (German Institute for Standardization)
DKG	*Deutsche Krankenhausgesellschaft* (German Hospital Federation)
DNR	Do Not Resuscitate
dpa	*Deutsche Presse Agentur* (German Press Agency)
DRG	Diagnosis Related Group
DVD	Digital Versatile Disc
ECHR	European Court of Human Rights
ECJ	European Court of Justice
ECM	Engineering, Procurement & Construction
ECR	European Court Ruling
e.g.	*exempli gratia* (for example)
EMTALA	Emergency Medical Treatment and Active Labor Act
EOT	Extension of Time
EPC	Engineering, Procurement and Construction
ERCL	European Review of Contract Law
ERM	Enterprise Risk Management
et seq.	*et sequitur* (and the following pages)
EU	European Union
EULA	End-User License Agreement
FASB	Financial Accounting Standards Board
FAQ	Frequently Asked Questions
FAZ	*Frankfurter Allgemeine Zeitung*
FDP	*Freie Demokratische Partei* (Free Democratic Party)

f.e.	for example
FIDIC	*Fédération Internationale des Ingénieurs-Conseils* (International Federation of Consulting Engineers)
FPG	*Fallpauschalengesetz* (German Case Rate Compensation Act)
GCC	*Bürgerliches Gesetzbuch* (German Civic Code)
GDPR	General Data Protection Regulation
GmbH	*Gesellschaft mit beschränkter Haftung,* (Limited Liability Company)
GMP	Guarantee Maximum Price
GoA	*Geschäftsführung ohne Auftrag* (Business Agency without Authority)
GOÄ	*Gebührenordnung für Ärzte* (Fee Schedules for Doctors)
GRC	Governance, Risk and Compliance Management
Green(s)	*Bündnis 90/Die Grünen* (Alliance 90/The Greens)
GTCB	German General Terms and Conditions of Business
HBRC	Housing and Building National Research Center
HC	Health Care
HGB	*Handelsgesetzbuch* (German Commercial Code)
HR	Human Resources
IACCM	International Association for Contract & Commercial Management
IAS	International Accounting Standards
IASB	International Accounting Standard Board
ibid.	*ibidem* (at the same place)
ICC	International Chamber of Commerce
ICT	Information and Communication Technology
ICU	Intensive Care Unit
i.e.	*id est* ('in other words', or 'that is')
IEC	International Electrotechnical Commission
IEEE	Institute of Electrical and Electronics Engineers
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standards
IfSG	*Infektionsschutzgesetz* (German Infection Control Act)
IJHCITP	International Journal of Human Capital and Information Technology Professionals
IJITCS	International Journal of Information Technology and Computer Science
IJKSR	International Journal of Knowledge Society Research
IP	Intellectual Property
ISO	International Organization for Standardization
IRZ	*Zeitschrift für internationale Rechnungslegung*
IT	Information Technology
IZA	*Forschungsinstitut zur Zukunft der Arbeit* (Institute of Labor Economics)
KBV	*Kassenärztliche Bundesvereinigung* (National Association of Statutory Health Insurance Physicians)
KHG	*Krankenhausfinanzierungsgesetz* (German Hospital Finance Act)

KHEntgG	*Krankenhausentgeltgesetz* (German Hospital Fees Act)
KoR IFRS	*Internationale und kapitalmarktorientierte Rechnungslegung*
KPI	Key Performance Indicator
LASIK	Laser-Assisted in situ Keratomileusis
LCalt	Leasing Contract (alternative)
LcPlan	Leasing Contract (plan)
LDs	Liquidated Damages
LG	*Landgericht* (Regional Court)
LOI	Letter of Interest, or Letter of Intent
Ltd.	Limited
M	Million
M&A	Merger & Acquisition
MDR	*Monatsschrift für Deutsches Recht*
MDK	*Medizinischer Dienst der Krankenkassen* (Medical Review Board of the Health Insurances)
Mio.	Million
MPBetreibV	*Verordnung über das Errichten, Betreiben und Anwenden von Medizinprodukten* (Ordinance on the Installation, Operation, and Utilization of Medical Products)
MPP	Maximum Plausible Position
NDA	Non-Disclosure Agreement
NEC	New Engineering Contract
NFR	Non-Functional Requirement
NJW	*Neue Juristische Wochenzeitschrift*
NPM	New Public Management
PC	Personal Computer
PEPP	*Pauschalierendes Entgeltsystem Psychiatrie und Psychosomatik* (Fee Schedule for Psychiatry and Psychosomatics)
P-MC	Pseudonym for name of health facility; with MC standing for medical center
PhilHealth	Philippine Health Insurance Corporation
PHP	Philippine Pesos
PPP	Private Public Partnership
PR	Public Relations
PSDA	Patient Self-Determination Act
QoS	Quality of Service
RCalt	Rental Contract (alternative)
RCplan	Rental Contract (plan)
RGSt	*Reichsgericht Strafsachen* (German Imperial Criminal Court)
SaaS	Software as a Service
SCT	Social Contract Theory
sec.	Section

SEC	Securities & Exchange Commission
SGB	*Sozialgesetzbuch* (German Social Code)
SHI	Social Health Insurance
SLA	Service Level Agreement
SME	Small and Medium-Sized Enterprise
SOP	Standard Operating Procedure
SPD	*Sozialdemokratische Partei Deutschlands* (Social Democratic Party of Germany)
SRM	Supplier Relationship Management
SSAE-16	Statement on Standards for Attestation Engagements No. 16
StGB	*Strafgesetzbuch* (German Criminal Code)
StPO	Strafprozessordnung (German Code of Criminal Procedure)
StVollzG	*Strafvollzugsgesetz* (German Penitentiary Code)
SZ	*Süddeutsche Zeitung*
UAE	United Arab Emirates
UHC	Universal Health Coverage
US	United States
USD	US Dollar
US-GAAP	United States Generally Accepted Accounting Principles
USFL	University of San Francisco Law Review
USR	Used Software Resale
VersR	*Versicherungsrecht*
Vol.	Volum
VP	Vice-President
WHO	World Health Organization

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Part I

The Concept of Contractual Management

Contractual Management—A Holistic Approach to a Diverse Issue

1

Ralph Schuhmann and Bert Eichhorn

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R. Schuhmann (✉)
Ernst-Abbe-Hochschule Jena, Jena, Germany
e-mail: Ralph.Schuhmann@eah-jena.de

B. Eichhorn
SRH Hochschule Berlin, Berlin, Germany
e-mail: bert.eichhorn@srh.de

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Abstract

This part of the book addresses two issues: The persistent complaints in business about the discrepancy between the immense amount of resources consumed by contracts and the rather limited effects they produce; and the neglect and lack of interest the contract faces outside of the legal profession, even though it is an essential

working tool for managers. To overcome these shortcomings, Sects. 1.1 through 1.3 survey contract deployment in respect of its concepts, relevance for enterprises, and integration into management activities; furthermore, the causes for the deficits in contract handling are analyzed. The results obtained call for a paradigm shift from **management of the contract to management through the contract**, what is referred to as the Contractual Management Approach (CM Approach). The latter is explained in Sect. 1.4 together with the Contractual Management Model (CM Model) which instrumentalizes the CM Approach. Thereafter, the benefits and limitations of Contractual Management are evaluated against the objectives of both concepts in order to capture all aspects of contract handling in business. Moreover, its applicability outside of business is tentatively explored to obtain better insights into the immutable conditions under which contracts work. In Sect. 1.5 finally, the core features of Contractual Management are highlighted as well as the contributions it can bring to improve the current shortcomings in contract handling and in contract appreciation.

1.1 The Phenomena of Contract

> The institution of contract includes irreconcilable ideas
> and discordant phenomena.
> (Robert A. Hillman)[1]

This section aims to promote a fresh and impartial view of the contract. It delineates the differing notions of the contract immanent to the various scientific disciplines, and in this way illustrates how the versatile steering potential of the contract can unfold in differing contexts. Such a view illuminates the management capacity that the contract can develop in business and beyond as well as for the transdisciplinary challenges it must meet in action.

Bertram Lomfeld postulates "Without contracts the world would be lonely and totalitarian." ([2], p. 1). What might seem like hyperbole at first sight becomes more reasonable upon closer consideration. In fact, the contract is a central phenomenon in our social reality and therefore our "world". It represents the counterpoint to society's claim of solidarity which it either resists or excludes ([3], p. 17). In **sociology**, Durkheim [4] considers the contractual relationship to be the heart of the social bonds within society, the latter being referred to by Max Weber ([5], pp. ii, 669) as "contractual society." Through contractualistic theories such as those of Hobbes, Locke, Kant, Rawls, Buchanan, etc., the contract is also of major importance in **political science** ([6]; [3], p. 3), in particular in political economy and under the term "social contract" as found in political philosophy. **Economics** considers the contract to be the bedrock of the market-based exchange of goods and services. According to Williamson ([7], p. 47), economic organization is a contract issue. The economics of contract thus delineates structures

[1] cf. [115], p. 123.

and processes between different companies as well as within individual companies through contractual mechanisms and logic. It understands contracts as reciprocal commitments of the contractual parties in terms of their behavior or, in other words, as bilateral coordination arrangements ([8], p. 3). From such origins, the contract developed through the New Public Management movement into a crucial instrument in public administration and led Lane ([9], pp. 147 et seq.) to coin the term "contractualization in the public sector." Finally, **legal science** considers the conditions under which a contract is to be recognized and enforced by the state authorities. Correspondingly, it primarily addresses contract law which constitutes a system of behavioral norms and conflict resolution mechanisms ([10], p. 206).

The aforementioned scientific approaches all focus on the same subject: the contract. At its core, it is a social phenomenon, a form of social cooperation. In addition, there are other forms of **social cooperation** such as family, status, or friendship. According to Selznick ([11], pp. 52 et seq.), the contract differs from these manifestations in two respects: Firstly, it originates from the will of the participants and is therefore voluntary, while other forms of human association arise from membership in a group and do not have a voluntary element. Thus, the contract forms a counterpoint to the demands of society: without it the world would be "totalitarian". Secondly, the contract covers performances that are limited in time and content, whereas other human associations such as friendship or marriage represent indefinite and content-wise diffuse promises and expectations.

The law, consequently, provides only one out of a number of perspectives on the contract and insofar constitutes the expression of a specific **functional view**. Likewise, the contract can be interpreted from the points of view of society, politics and economy. Such different functional perspectives may result in diverse concepts of the contract ([10], p. 19). According to economic contract theories, for instance, the contract encompasses not only private agreements but also corporate constitutions and political rules and therefore extends beyond the legal concepts of the contract ([12], pp. 5–6). For Schmid ([10], pp. 59 et seq., 199), law is not even a precondition for a contract. This is confirmed by business practice, which largely relies on contracts without having the intention to use them for legal enforcement: Social stigmatization, which goes hand in hand with a loss of reputation, will in most cases ensure adherence to contractual promises more efficiently than legal sanctioning ([13], pp. 60 et seq.; [3], pp. 126 et seq.; [10], pp. 101 et seq.). Political science in turn instrumentalizes the contract as a construct for legitimizing governance and therefore addresses a different question set and applies a different concept of contract ([6], p. 12). The phenomenon of contract thus can only be comprehended through the overall understanding of all its different functions.

When considering the contract through the perspective of its rationale, its spirit and purpose, a discourse on the meta level of contract arises. In this regard, Lomfeld [2] distinguishes four "reasons for the contract":

- **Freedom** through personal will and responsibility;
- **Security** through stability and trust;

- **Benefit** through efficiency and risk;
- **Justice** through fairness and equivalence.

For the above-mentioned reasons, Lomfeld demonstrates that the contract is not only instrument for the realization of benefits within private cooperation but also of benefits on a collective level. All of the "reasons of contract" can and have to be interpreted in light of social processes and institutions. Private autonomy, for instance, is not only the means for realizing individual freedom but also the instrument of regulatory policy. This two-sidedness is mirrored in the legal policy discourses on standardization vs. individualization, transparency vs. control, and individual benefit vs. public interest. The same applies to the reason of justice, which, besides addressing general fairness and equivalence, in terms of distributive justice contains a social dimension. The benefit of the contract has a social dimension too, since it brings two or more parties to identify mutual interests and then to initiate and control their realization. Kersting ([6], p. 18) designates contracting as the ultimate consent-generating process ("*das konsensgenerierende Verfahren schlechthin*"). Both the English term contract as well as its counterparts in legal systems of the Romance languages such as '*contrat*' in French and '*contrato*' in Spanish originate from the Latin verb 'contrahere' (=bring/draw together) and highlight the creation of a unity through the contributions of the contractual parties. From a negative perspective, the contract manifests in the refraining of all parties to make use of certain rights; this aspect is reflected by the German term '*Vertrag*', which can be linked to the verb '*vertragen*', which means (to) tolerate or (to) endure [14]. Thus, the contract is not only a form and expression of social relationships, but it also creates the latter. The more modern society disintegrates, the more the contract gains relevance since it may replace social ties to a certain extent: without it, humans would be "lonely". In this regard Collins ([3], p. 25) speaks of a "contractualization of social relations".

The enforceability of obligations that have been voluntarily agreed upon by the contractual parties characterizes the **contract as an institution of law**. It relies on state institutions, in particular on courts and the legal system. The Restatement (Second) of Contracts [15] provides the following definition of the contract in Chapter 1, subsection 1: "A contract is a promise or a set of promises for the breach of which the law gives a remedy, or the performance of which the law in some way recognizes as a duty." If, for example, parents agree with their 14-year old son that they would reward a good grade in math with EUR 20, then this arrangement is a contract from a social point of view. From a legal perspective, this arrangement is not a contract because the parents lack the intent to legally bind themselves; it is a social but not a legal obligation. If, however a businessman agrees to the delivery of a good for a specific price with a business partner with whom he or she has been in a continuing relationship, this arrangement is considered binding and qualifies as a sales contract. Besides this legal arrangement, the social relationship between the business partners continues and affects the handling of the contract and vice versa. Should a delay in delivery occur, it is quite conceivable that a due

contractual penalty might not be pursued in light of previous relationships or of future business transactions. Beyond this, the situation also has an economic dimension since it raises issues about the design of an efficient exchange of goods.

The contract as a legal institution may be encountered in various fields:

- In business, for instance in a contract governing the sales of software licenses (see Chap. 3, The Second-Hand Software Case);
- In the domain of state actions, for instance in a research contract receiving public support (see Chap. 7, The Ultra-Long-Distance Energy Transmission Case);
- In society, for instance in joining a sports club as a member, in a coalition contract signed between political parties (see Chap. 12, The Jamaica Coalition Case), or in a social contract setting (see Chap. 11, The PhilHealth Case).

This book explores the handling of a contract in business. However, in order to reflect upon these phenomena, it is useful to consider the functionalities of the contract in areas outside of economic contexts. In Sect. 1.4.7.3 and the last two case studies in Part II, the contract is therefore also examined in selected social and political settings.

1.2 Contracts in Business

Section 1.2 narrows down the view to the deployment of contracts in a business environment. It outlines the way in which the contract is perceived by managers as well as its function, purpose, and relevance for companies. Thereafter, specific consideration is given to the way management theory and practice make use of the contract and integrate its handling in business processes. It becomes apparent that the contract's management capacity is only acknowledged and utilized to a limited extent.

1.2.1 Scientific Approaches to the Subject

Scientific knowledge about the deployment and effects of the contract in business is abundant, and provided primarily by the fields of microeconomics and sociology which both refer to their own 'contract theory'. Microeconomics, and in particular New Institutional Theory, addresses the issue of how an economic actor has to construct a contract in a world that is not ideal. Economic contract theory and its logics of control and incentive exercised considerable influence on business administration theory. However, it focuses primarily on the design of the contract but not on its actual handling in a given setting. New Economic Sociology partly contradicts the assumptions of economic contract theory by highlighting in particular the aspects of 'embeddedness' and 'networks' (e.g. [16]). From legal sciences and legal sociology, relational contract theory, developed by Macneil [17] in a series of articles, has contributed to a functional

understanding of the contract, and relational contracting is widely applied in specific fields of business (e.g. [18]). Traditional legal sciences however have kept their distance from the subject of contract deployment ([19], p. 318) as has traditional management science ([20], p. 337). Although scientific fields like economics and law, economics and sociology, legal sociology and political economics have emerged at the intersections of different disciplines, the diverging perspectives and positions regarding the contract and its deployment have thus far not been reconciled.

Approaches of applied sciences consider the contract primarily under the aspect of problem and conflict avoidance and thus of transaction planning. This holds especially true for the preventive law theory [21], which has been taken up in particular by legal advisory professions in the US, and for the proactive law theory [22], which developed in Scandinavian countries. Both are action-oriented but focus on contract creation rather than contract execution; they bear very little connection with the approaches of microeconomics and behavioral science.

1.2.2 Contract and Business

1.2.2.1 The Notion of Contract in Business

As already discussed, scientific disciplines adhere to different concepts of the contract according to their respective objectives. A similar phenomenon can be observed in business practice: In his hallmark study from the 1960s, Macaulay ([13], p. 10) stated that often

> "businessmen do not feel they have 'a contract'—rather they have 'an order'. They speak of 'cancelling an order' rather than 'breaching our contract'."

The legal and business perspectives on the contract are thus not the same. Haapio et al. ([23], p. 50) in turn reported that in business the contract is understood as a legal instrument made by lawyers for lawyers. While this may at first seem contradictory, it makes sense when taking into consideration that contract and order constitute different sides of the same matter and that professionals tend to see only one side—'their' side. Several authors point out that a professional's view on the contract will vary according to his or her role in a company ([3], pp. 135 et seq.; [24], pp. 156 et seq.; [25], p. 46). Thus, a sales manager will have a different notion of the contract than an accountant or an in-house lawyer. The contract in the sense of the legal doctrine exists only in the minds of the lawyers, unless a situation emerges where the contract is brought to dispute and non-legal perceptions temporarily recede to the background also for legal laymen. The contract thus resembles a chameleon: depending on the role of the onlooker and the situation, it can be primarily legal, primarily business, or primarily relational (social).

1.2.2.2 The Practical Relevance of Contracts

Every economic exchange of performances occurs on the basis of a contract. The number of contracts found in a company can be enormous, considering that an average Fortune

1000 company has between 20,000 to 40,000 suppliers ([26], p. 4). For big companies, this can easily amount to more than one million active contracts; [27]. Between 60 and 80% of all B2B-transactions are performed on the basis of formal written contracts ([28], p. 18), which in many cases need to be drafted and administered with considerable effort and expense. According to a report first published in 2015 ([29], p. 1), the average cost for processing and reviewing an everyday contract in business amounts to US$ 6,900. Cost for a mid-complex contract averages at US$ 21,000, while for highly complex contracts the figure is US$ 49,000 but may run into several hundreds of thousands in a single case. Almost every department of a company has to deal with contracts in one form or another ([30], p. 91). From a functional point of view, they are the central instrument for controlling the behavior of business partners, but also hold relevance in intra-corporate monitoring. Contracts represent the most important means for allocating risks, and improper handling constitutes a severe source of risk for a company. Besides that, the contract pool of a company contains an enormous volume of data pertaining to transactions and beyond.

Despite its enormous theoretical importance and high incidence in practice, the contract's actual relevance for business is in dispute. Macaulay [13] pointed out in his aforementioned study that managers in the US attach no particular significance to contracts and consider other factors to be far more important for transaction success. For them, contracts rarely play a major role and only when the transaction is particularly important or personal conflicts arise.

Subsequent empirical studies appear to confirm Macaulay's findings; cf. the overview at ([32], pp. 24 et seq., [33]). They, however, share his perception of the contract as a means to enforce promises made by the parties and thus focus on its legal functions. A different line of research, which understands the contract as an instrument to coordinate the behavior of the contractual parties, on the other hand, presents a set of empirical findings which underscores the considerable relevance of contracts in business ([34]; [35], p. 44; [32]; [19], p. 325). In the end, the outcomes of both approaches are not so far apart; only their focus varies and in consequence they address different phenomena. Macaulay, in this regard, repeatedly mentions that the purpose of a contract is to convey a feeling of security to the parties, which they need in order to invest in the transaction. While the commitment expressed through the contract does not necessarily yield the fulfillment of the contract, it nevertheless brings about an act of performance which is sufficient for business people. In Macaulay's view, parties carry out performances because they signed a contract and not because of, and in compliance with, any specific content of the contract.

With this, Macaulay anticipated two views on the contract that were to establish themselves at a much later time. For one thing, the relevance of the contract is seen today in its provision of a ritual as well as in the reflection of a tradition. Amongst other reasons, a contract is therefore concluded because it is a common practice and the business partner expects such a process. Thus, the focus of this approach is primarily on procedure and less on content. Secondly, the contract is perceived as an instrument for

building of trust between the parties, meaning that its purpose is to convince the partner of one's own commitment.

Against this background, the seemingly surprising results of Arrighetti et al.'s study on contract law ([34], pp. 171 et seq.), social norms and inter-firm cooperation in the mining equipment and kitchen furniture industry in Germany, the United Kingdom and Italy can be interpreted in a meaningful way. Although 100% of the German companies were found to act "always" or at least "sometimes" on the basis of a written contract, only 5% of them reported a lawsuit against a customer or supplier as "likely," whereas 41% considered litigation as "unlikely" and 54% as "very unlikely." In contrast, 45% of the British companies deemed litigation as "very likely" and 15% as "likely" or "rather likely". These findings lead to the conclusion that, while the contract itself is considered to be relevant, its legal enforceability is not in any case.

1.2.2.3 Functions and Purposes of Contracts

Scientific research underpins the manifold roles and effects of contracts. There is a far-reaching consensus that the **contract's function** is to support the coordination and/or control of the behavior of its parties ([36], pp. 49 et seq.; [37]; [38], pp. 108 et seq.). In order to fulfill these tasks, secondary functions have been identified, in particular: clarifying the responsibilities of the parties ([10], p. 102; [3], p. 150); reducing uncertainty ([35], pp. 47 et seq.; [39], p. 262); guiding communication within and between companies ([39], p. 263; [13], p. 45); as well as building trust between the partners ([35]; [19], p. 329).

Contract purposes, in contrast, relate to the contract's effects intended by the parties. Here, three fundamental approaches can be observed:

1. Contract implementation is geared towards the execution of the contract provisions;
2. Relational contracting considers the social norms systems which exist alongside the law and from which further normative rules such as loyalty, respect, and courtesy are derived;
3. Relationship management [40] focuses not primarily on the contract and transaction but instead on the enterprise and its long-term goals and interests. Considering solely contract efficiency is seen as counter-productive as the overall objectives of the enterprise can be jeopardized through an overemphasis on short-term transaction success.

1.2.3 Contract and Management

The contract can be related to management in two ways: It can be the object of management or it can be used as a means of management. The first approach is contract-focused and in widespread use as contract management (Sect. 1.2.3.1); the second is management-focused (Sect. 1.2.3.2) and in its early stages of development.

1.2.3.1 Contract-Focused Approaches

1.2.3.1.1 Contract Management

Contract management can be defined as the creation, execution and analysis of the contract ([41], pp. 1–2). Thus, it deals with and is centered on the contract. Usually, it applies the concept of the contract lifecycle management ([28], pp. 12 et seq.), which organizes the various activities related to a contract—i.e. maintaining model contracts, drafting the contract, negotiating its terms, controlling its execution, change and claims management, archiving, etc.—along its life cycle. Depending on the type of transaction, two forms of contract management can be distinguished ([30], p. 101): Unique, complex transactions (especially those in project business, M&A, investment, and R&D) are dealt with individually with a view to optimize the management of the transaction, whereas for transactions in mass business, it is not the individual contract that is considered but a contract portfolio. Both forms of contract management primarily address either the issue of 'visibility of contract', and thus enterprise objectives, or they focus more on contract implementation and thus on operational goals. The latter manifestation is commonly called 'Contract Administration' ([42], p. 21), a term frequently used as a synonym for contract management. However, a precise use of terminology has not yet emerged in this field.

1.2.3.1.2 Contract and Commercial Management

The development of the occupational image of the **contract manager** ([43], pp. 173, 178) as well as the emerging approach of proactive law [22] have led to new insights into the interaction of contract and management. They replenish the knowledge about the functioning and deployment opportunities of the contract that has accumulated considerably during the past two decades due to the developments in risk management, contract lifecycle management, and corporate governance.

In parallel, the occupational image of the contract manager or, rather, contract and commercial manager has developed which encompasses the product-specific (f.e. engineering), economic and legal tasks of a manager and therefore addresses professionals with various educational backgrounds. Its professionalization is mostly governed by the two major international associations in this field, the International Association for Contract and Commercial Management (IACCM) with more than 43,000 members and the National Contract Management Association (NCMA) with more than 20,000 members. Both publish various journals and have significantly contributed to the development of contract management.

Contract and Commercial Management, however, seems to still be at its beginnings. Lately, it is increasingly being explored further along the lines of concepts such as added value, outcome orientation, performance measurement, competitive advantage, etc. It thereby moves towards goals and purposes that are significantly beyond those of ordinary contract management and expands into the realm of the management-focused approaches.

1.2.3.2 Management-Focused Approaches

In recent years, a growing tendency to incorporate business goals into contract management can be observed in theory as well as in practice. However, only a few approaches are committed to the partial or full deployment of the contract to systematically address management issues. They will be dealt with briefly in the following sub-sections.

1.2.3.2.1 Contractual Risk Management

In business, the contract's capacity to allocate and to mitigate risk is a widespread notion based on everyday professional experience beyond any scientific foundation. Many authors from practice therefore do not see the necessity for a theoretical justification of such an approach (e.g. [44–45]) or refer to the contract as a risk management tool without further explanation (e.g. [46–47]).

Theoretical foundations for this approach were laid for the first time when Keskitalo developed his theory of Contractual Risk Management. It is oriented towards the contract's capacity to contribute to the governance of the transaction (Contractual Risk Management) [48] as well as of the enterprise (Contractual Enterprise Risk Management) [42]. Although it is far from being widely accepted, it has gained some proponents predominantly in the Scandinavian region ([49–50]; [51], p. 223). As it was derived from the proactive law theory, it is nonetheless dominated through the lawyer's perspective and deals primarily with contract design and contract management.

1.2.3.2.2 Contract Governance

Although Williamson's governance theory was initially developed with a view to contractual relations [52], it quickly gained relevance for the control of institutions and substantially contributed to the corporate governance movement ([53], p. 2). Its concept, however, is far from being clearly delineated. Möslein and Riesenhuber ([53], p. 3) describe it as "the entirety of the various collective impacts on a social system." Consequently, governance takes an interdisciplinary position and includes contributions from economic, social and legal sciences. Its main focus, however, is on the structure of institutions that shape behavior and "not so much on result-driven steering mechanisms" (ibid.). The governance theory subsequently gained considerable influence on public sector theories. It is only recently that the interest of research in governance is returning to the contract under the label of Contract Governance (ibid.) or Contractual Governance ([19–54]).

1.2.3.2.3 Steering by Contracts

The understanding of the contract as a steering instrument originates from economy-based theories and in particular agency theory ([55], p. 1). Until today, the term 'steering by contracts' has only established itself in the public sector, especially in publications on New Public Management (ibid.). Its concept however does not aim to improve

transaction efficiency but seeks to facilitate the strategic control of an administrative agency by a superordinate administrative or political entity ([56], p. 329).

1.2.3.2.4 Contractual Management

Based on Keskitalo's theory, presented in Sect. 1.2.3.2.1, the editors of this book have introduced the Contractual Management Approach in previous publications [57–58]. It combines the interdisciplinary perspective of the Governance theory with the operational focus of contractual risk management theory. In contrast to Keskitalo's concept, however, Contractual Management operationalizes the contract's management potential not only with respect to the enterprise, but also, and to the same extent, the transaction.

1.2.3.3 Inventory: Contract and Management Processes in Enterprises

In order to operationalize the contract for management purposes, it is necessary to identify all processes within a company which either need to be supported by the contract or which in turn are necessary to handle it (Sect. 1.2.3.3.1). Thereafter, such **contract-related management processes** have to be checked with regard to their intensity of networking, i.e. their integration into the enterprise's management systems (Sect. 1.2.3.3.2) which is a prerequisite for the optimal utilization of the contract for managerial purposes.

1.2.3.3.1 Contract-Related Management Processes

The contract is connected to corporate processes in various ways, and almost all departments in an enterprise have to deal with it in one way or another. Figure 1.1 arranges the most important contract-related management processes according to the three subjects of management in a company: enterprise, relationship, and functional unit. For the sake of clarity, each process is only included once based on its primary relevance, even if it involves several of the subjects of management mentioned. Contract management, for instance, serves the management of transactions as well as of the enterprise. Since it is primarily deployed as an instrument of corporate governance, Fig. 1.1 displays it only for the enterprise-oriented processes. In terms of the functional unit, further processes could be attributed as well, for instance in the field of HR. Moreover, it should be stressed that the depiction serves to showcase the contract-related management processes and consequently refrains from displaying the many overlaps and interrelations of such processes.

The top section of Fig. 1.1 displays contract-related management processes aimed at the enterprise. **Corporate management** refers to the outcome-oriented design, control, and development of a company ([59], p. 25). Mostly, it addresses contracts only indirectly since they are a phenomenon of business operations. It can impact contracts through business process management but also ad hoc through strategic decisions concerning e.g. business partners, business types or the use of resources. It may also be directly involved if contracts are of strategic importance, e.g. in Merger & Acquisition or for strategic alliances. The strongest links with contracts arise from **corporate**

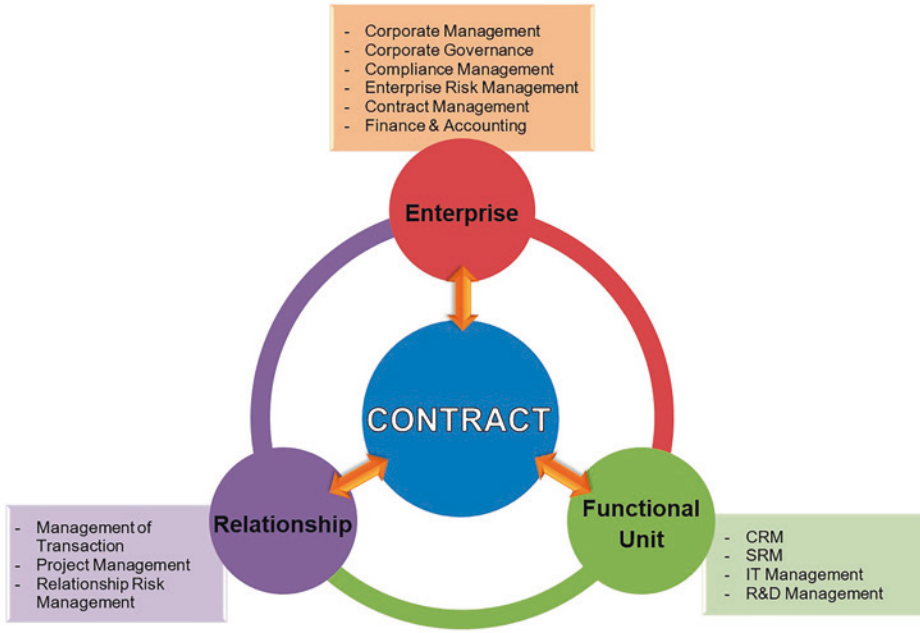

Fig. 1.1 Contract-related management processes

governance which forms part of corporate management and hereby incorporates in particular compliance management and enterprise risk management, but also contract management. **Compliance management** serves to ensure adherence to legal norms and quasi-normative provisions adopted by an enterprise as internally binding rules. According to its theoretical concept, it includes contract compliance, which is concerned with the actual execution of the commitments stipulated in the contract. **Enterprise risk management** (ERM) addresses the risk exposure of the enterprise and records high risks from single transactions, for example the outsourcing of IT services, as well as aggregated small-scale risks. **Contract management** derives from enterprise risk management, and therefore ultimately from corporate governance, and aims at the protection of the enterprise against contract handling risks. Although it deals with contracts and thus has an effect on transaction risks, it is geared primarily towards the protection of the interests of the enterprise itself. **Finance and accounting** also display a considerable number of processes which are closely linked to the contract and directed towards the support of corporate management, e.g. relating to accruals, annual accounts and auditing.

The left-hand side of Fig. 1.1 displays a number of management processes which are primarily directed towards the external relationships of an enterprise. They can be exchange relationships (transactions) or associations such as joint ventures, consortia, strategic alliances, etc. (business cooperations). Transactions, unlike business cooperations, have been attracting close attention from academics and practitioners

of contract management. For the management of complex and long-term transactions, specific processes exist under the domain of **transaction management**, in particular in the fields of real estate, M&A, and foreign currency exchanges. In business informatics however, the term transaction management has a completely different meaning. **Project management** is equally oriented towards the single transaction. Since the contract works as an instrument to allocate and to manage the risks from a relationship, it constitutes an important point of reference for **relationship risk management** which covers risk management processes with a primary focus on the business cooperation or the transaction. In projects, such risk management is performed under the name of project risk management. In a narrower sense and related only to contract risks, the term **contract risk management** is widely used in several industries ([26], p. 6) and designates another manifestation of relationship risk management. According to many scholars, the initiation and processing of transactions is not to be considered a management activity since it only follows pre-defined processes. This is particularly true for bulk business, where the deals show only a small degree of variance, for instance in e-commerce sales, and the single transaction is not encompassed by a corresponding individual management process.

Finally, the contract can contribute to the management of a functional unit as displayed on the right-hand side of Fig. 1.1. Such activities may include the governance of outsourced service portfolios for IT or for research and development (R&D), the handling of framework agreements for strategic sourcing, or data generation for marketing purposes, for instance by analyzing client contracts. Since contract handling in this field does not show substantial particularities as compared to the management of a relationship or an enterprise, it will not be considered further in the following pages.

1.2.3.3.2 Contract and Management Systems

The interlinking of the various contract-related management processes has progressed to differing degrees in practice but overall is still in the early stages of development. As already explained, there are obvious connections between **enterprise risk management and relationship risk management**; also, contract management and risk management nowadays are often linked, and the market provides numerous integrated software solutions. **Corporate governance, compliance management and risk management** are already highly integrated at the enterprise level through the concept of Governance, Risk and Compliance Management (GRC) (e.g. [60–61]) which is widely accepted, although its pervasiveness in practice is subject to dispute ([62], pp. 461 f.). A corresponding concept for the transaction level, however, has not yet developed.

Although the contract's function as a carrier of information and a channel of communication is broadly acknowledged, the contract does not play any role in GRC concepts. Only Keskitalo ([42], pp. 26–27) considers **knowledge management** as the axis around which contractual enterprise risk management, which shows similarities to the COSO ERM Integrated Framework, is arranged. GRC software solutions, however, support at least two of the three activities of contract knowledge management ([63], p. 43):

the implementation and the analysis of contracts. Regarding the third activity of contract knowledge management—the creation, processing, and provision of internal and external knowledge relevant to a transaction—research literature is silent and business practice primarily relies on sporadically linked, isolated solutions.

The research literature on contract management mirrors a bottom-up development and displays only attempts at systematically linking the various contract-related management processes. Driven forward by the needs of daily operations, business practice seems to be more advanced than theory which appears to be trapped in the **self-restrictions of the respective academic discipline**: Management science understands the contract primarily in legal terms and takes little account of it, while legal sciences almost completely avoids pertinent managerial questions ([30], p. 89). Contract management literature thus stems primarily from lawyers who emphasize the importance of risk in drafting contracts and focus on contract risks rather than on transaction risks. Risk management, in turn, is dominated by business administration and treats the contract—if at all—as a source of risk and at best as an instrument for transferring risks (cf. e.g. [64], pp. 141–142). Finally, it is essentially only business informatics that is undertaking to operationalize the data, logics, and processes provided by or established in the contract. It is not surprising, therefore, that a holistic approach oriented towards the management potential of the contract has not yet emerged.

Among the management concepts which are related to contract and are in common use today, only contract management and enterprise contract management (ECM) [28] recognize the contract as an essential management factor. This is obviously due to the fact that their main focus is on the contract anyway. The manifest **neglect of the contract** in other fields of management underlines the common notion of the contract as being of relevance for legal and not for management matters.

1.3 Challenges of the Contract in Business

This section serves to evaluate the actual performance of contracts in business. Since the results are far from satisfactory, the causes for the present shortcomings are analyzed as well as the challenges that contract deployment will have to face in the future. Both subjects of analysis demonstrate that the full potential of the contract can unfold in business only by way of a paradigm shift in contract handling.

1.3.1 Current Shortcomings

Despite many theoretical studies and a growing empirical database, no clear picture of the use of the contract in business can be drawn. Apparently, enterprises handle contracts mostly in a short-sighted if not entirely unreflective manner and follow traditional company and industry practice instead of an explicit contract strategy with defined goals,

KPIs and performance measurement. The disappointments with contract performance reported from practice thus indicate negative experiences rather than failure in achieving defined contract objectives.

1.3.1.1 The 'Contract Compliance Issue'

Knowledge on the usage and effects of the contract in business is scarce and many findings are only based on anecdotal evidence. It is consistently emphasized however that contracts are frequently not implemented according to their content ([3], p. 137; [30], p. 91). The Aberdeen Group survey ([65], p. 2) revealed that in best of class enterprises, 83% of the transactions are compliant with contract whereas for all others the rate is 56%. This may be due to several reasons, the most important being the 'embeddedness' of contracts. Although concepts and terminology differ, all relevant scientific disciplines agree that the contract only provides one out of several sets of norms which guide the behavior of the contractual parties. Thus, a transaction will be governed by the formal contract but also by ethical considerations and industry practice as well as the needs of the 'economic deal' and of the business relations ([3], pp. 128 et seq.). Macaulay [25] accordingly refers to the 'paper deal' and the 'real deal'. But there are also further causes which are closely linked to the contract's presentation and perception: It has already been stated above, that the notion of the contract differs according to the role and education of the professional involved. This attitude, however, will influence the way a contract is handled. As Jacob [66] puts it:

> "Lawyers and paralegals used to be focused on security—making sure contracts are 'watertight' and pose little risk for the company if the case ever went to court. And contract-handling personnel in sales, purchasing and other lines of business simply tried to jump over internal 'legal hurdles' and get contracts done as quickly as possible."

A third reason, finally, lies in the legalistic appearance of contracts, resulting in the fact that managers often do not, or only reluctantly, read contracts ([3], p. 153; [23], p. 49) and frequently do not understand them ([67], p. 258; [68], p. 1450). It is not surprising therefore that line managers consider contracts to be burdensome ([23], p. 49), superfluous ([13], pp. 10–11) or even hazardous (ibid.) and try to make as little use of written contracts as possible.

1.3.1.2 Challenges in Contract Management

Contract management is in widespread use today, mostly applying the contract lifecycle management approach. A best practice however has not yet emerged, and contract management is still considered to be in a premature stage ([30], p. 202). Despite substantial investments in corresponding management systems, enterprises are highly dissatisfied with the results. An independent study carried out by IACCM in 2011/2012 estimates the average annual losses in revenue caused by insufficient contract handling at 9.2% [69]. A similar impact is reported by various other sources ([65], p. 2 et seq.; [70], 2013, p. 5; [28], pp. 19 et seq.).

A closer investigation of contract management practice in 100+Global 2000 companies undertaken by Krappé and Kallayil [26] in 2003 offers clues about the causes for such losses revealed *inter alia* that

- 81% of the companies face problems in simply finding a contract;
- 54% have difficulties accessing specific terms and clauses in contracts;
- 40% say that they could achieve substantial savings with a better contract management;
- 75% consider contract risks as a major concern;
- 61% have no idea of the interdependencies of their contracts;
- 60% do not track contingent liabilities for contracts.

Notwithstanding considerable efforts to improve the situation, these shortcomings essentially persist to this day. According to a 2010 BearingPoint study, only 8% of the participants were satisfied with all aspects of their enterprise's contract management ([71], p. 51), matching the findings of IACCM's member survey according to which 89% of the respondents believe that contract management processes must improve ([72], p. 7). Areas of particular concern are centralization of contract management activities and the use of comprehensive software solutions. For the 2010 BearingPoint study, only 9% of the participants reported that all contract management tasks were fully centralized, whereas 50% stated an execution completely by individual departments or employees ([71], p. 38). In terms of software support, an IACCM survey revealed that 62% of the participating member organizations had adopted contract management software but less than 20% of them made widespread use of it ([73]). All in all, contracts are frequently handled in an unsystematic, fragmented and largely manual manner ([74]; [28], pp. 11–12) and even major companies are still **struggling with the basics of automation** such as capturing all contract data, workflow and contract building blocks, central repository, contracts analytics, e-signature, etc.

1.3.2 Causes for the Shortcomings

Inadequate contract handling in business can be attributed to five structural hindrances which result from a mixture of misjudgment, conceptional deficits, and factual constraints.

1.3.2.1 Lack of Contract Strategy

Contracts typically aim at the legal protection of corporate interests ([23], p. 51 et seq.); further functions or purposes are scarcely reflected upon in practice and implemented even more rarely. Thus, in most cases, contracts are not designed with sufficient preparation time and to a suitable extent ([75], p. 26; [76], pp. 26–41; [31], p. 467) but instead follow corporate and industry practice. Planning-centered scientific approaches such

as the proactive law and the preventative law theories have not established themselves in business practice. As a result, contracts only have a limited and somewhat random capacity to support the realization of transaction goals and strategic objectives.

1.3.2.2 Emphasis on Legal Issues

In accordance with traditional perceptions, the contract is mostly oriented towards legal risks and not towards business risks. The annual member surveys of ICAAM show that the "most negotiated terms" are not considered to have the highest practical relevance for the enterprise. For instance, 'limitation of liability' figured as no. 1 in negotiations, yet it is only ranked on position seven of the "most important terms" ([77], p. 9). Hence, design and negotiation of the contract are heavily burdened by legal considerations and objectives which may conflict with the requirements for positive and cooperative relationship building. It is therefore not surprising that line management considers the contract to be only minimally helpful if not inhibitive and tends to circumvent it or implement it in deviation from its content.

This legal focus manifests itself not only in contract management ([42], p. 22) but also in contract risk management. In business, contract risks are essentially understood as contractual liability risks ([58], p. 508) but not as risks for the transaction generated by the contract and its handling (ibid., pp. 509 et seq.). As a result, the contracts delineate the risk profile of the respective business only partially and in a distorted manner and therefore can be used only to a limited extent to guide the management of the transaction.

1.3.2.3 Addressees Out of Focus

In business, contracts are commonly created "by jurists for jurists" on the basis of sample contracts. This not only affects their content, but also their presentation. It is empirically proven, however, that the design and wording of contracts often exceed the cognitive abilities of non-lawyers ([78], p. 376). Contracts are thus read only reluctantly or superficially and are often—as has particularly been researched for construction contracts—not properly understood ([67], p. 258; [68], p. 1450). However, an insufficient and therefore differing understanding of the contract between its parties is the primary cause for dispute.

In order to implement contractual stipulations, the decision-maker must understand them, and to this end he or she needs to read them. Traditionally, contracts are drafted only textually and show specific legal features in language style and mode of design: Long sentences, numerous references, textual redundancies, high information density, passive voice, nominalizations, legal terminology, and lack of a reader-friendly layout. Such traits make comprehending the contract difficult to legal laymen and may deter them from applying it. Bunni ([79], pp. 9 et seq.) showed that only 4% of the population are readily able to understand 86% of the 1997 FIDIC Red Book, a standard contract frequently used in the construction industry. This corresponds with the findings of Rameezdeen and Rodrigo ([80], pp. 6 et seq.), according to which 95% of the 1995

FIDIC Red Book stipulations require a university reading level and more than 50% even necessitate post-graduate-level comprehension. IACCM's 2018 report on the most negotiated terms ([77], p. 4) confirms such assessment, stating that 88% of business users find contracts "hard or impossible to understand."

To a limited extent, legal linguistics provides some indications that factors such as sentence length and complexity, information density, terminology, and information structure are relevant for the comprehension and emotional acceptance of a text. Difficulties in understanding contract passages in English are linked, among other things, with complex sentence structure that overstrains the cognitive capacity of short-term memory ([81], p. 38); on average, 20 words are considered to be the critical sentence length ([67], p. 256; [80], p. 8). Furthermore, communication style also aids in comprehension: Active voice is usually more easily understood than passive voice (ibid., pp. 64 et seq.); the same applies to verbalizations instead of nominalizations ([68], pp. 1451–1452); a personalized address ("you") leads to a more direct and thus appealing approach than an impersonal one ("the service provider") ([82], pp. 69–70); a writing style based on spoken language reflects the interpersonal connection better than typical written language (ibid., p. 70). The last two factors are particularly relevant for the trust-building function of a contract.

Efforts have been made for a while to reduce these deficits in contract presentation. They aim at aligning the contract's appearance towards the abilities and expectations of its users. This change of paradigm has been very aptly termed the "ergonomics of contract" ([78], p. 376; [83]). In several Anglo-Saxon and Scandinavian countries, these approaches have yielded a high degree of permeation into practice, in particular by using 'plain language' for contracts. For instance, there is evidence that the NEC2 contract, a standard contract for construction projects which has been specifically designed for non-jurists, is better understood than its predecessor and has a lower conflict potential than comparable standard contracts. With regard to other approaches like visualization or innovations in the layout and structure of contracts, experiences from practice are still few in number.

1.3.2.4 Contract as the Subject of Management

Contract management deals with the **management of the contract**; it is concerned with efficient contract handling in enterprises. Two main lines of development are particularly prominent today. One aims at the 'visibility' of the contract and its provisions ([26], p. 4) and thus the data stored in the contracts at all its processing stages and their availability for every relevant company function. The second is centered on the effectiveness of contract handling and deals with issues such as ignition to signature times, authorization and approvals, contract obligation performance management, etc. Both lines of development require a high degree of standardization and centralization as well as comprehensive IT solutions ([71], pp. 39, 53 et seq.). The contract's capacity to manage, i.e. its ability to guide and support decision-making in the management of a relationship and an enterprise, however, is beyond the focus of contract management.

The focus on the contract itself has a particularly negative impact on the management of a transaction:

- The steering capability of the contract cannot be fully used because the contract is not systematically deduced from the requirements of the transaction;
- There is insufficient alignment between strategic, operational, and legal objectives of contract handling;
- The affected management processes are insufficiently interlinked, for instance relationship risk management is not interwoven with contract risk management, and contract management is not connected with knowledge management.

In consequence, contract performance compliance shows severe deficiencies.

1.3.2.5 Corporate Versus Transaction Governance

The effects of a contract are not only dependent on its content and presentation, but also upon the context in which the contract is used. In other words: The same contract will produce different outcomes if deployed in a different environment. In bulk business, the crucial transaction parameters are essentially the same and a standard contract can therefore be expected to generate predictable results. In individual business, this will be different as the effects of the contract are dependent on the specific relationship of the partners which can vary broadly from collaborative to hostile. The more a contract is aligned with a specific relationship, the more it can influence and control it. However, the paradigm of efficiency has meanwhile also reached contract management ([30], p. 94) and has led to a push for consistent centralization and standardization for contracts. The customizing of contracts for individual business can be reconciled with such development only to a limited extent. As a consequence, transaction and corporate interests may compete with each other, leading to a negative impact on either contractual compliance or transaction result. This is why GMP contracts (Guaranteed Maximum Price contracts) didn't produce the expected results in the German construction industry, which tends to have an adversarial mindset that conflicts with the collaborative concept of the GMP contract ([84], pp. 8 et seq.). Conversely, there is considerable evidence that extensive and very detailed contracts may have a negative impact on the trust of a business partner ([35], p. 46) and thus on his commitment and willingness to cooperate.

1.3.3 Challenges of the Future

While contract handling is still struggling towards the basics of automation, developments in information and communication technology (ICT) have been ringing in a new era of 'post-automation' [66] which will bring fundamental changes to the handling, content, presentation, and functions of contracts. Although there may be an overoptimistic notion today of what is technically possible and economically reasonable in the near future, the features of prospective contract handling are already discernible:

- **Contract handling** Automated contract drafting, one of the early fields of software application to contract handling, is fairly advanced and now receiving further stimulus from artificial intelligence and machine learning. At present, automated contract implementation through self-executing agents, so-called 'smart contracts' [85], is revolutionizing contract execution. Although a general roll-out of blockchain technology, which is presently being used mainly for virtual currencies and in logistics, may look like a far-off vision in particular with respect to complex transactions, it shows the way into the future. Moreover, with the spread of the autonomous conclusion of contracts as discussed for the Internet of Things, an end-to-end digital management process of contracts becomes apparent. Some authors even stress the possibilities of autonomous contract negotiations between machines in the near future ([86], p. 4689) as well as autonomous change and dispute handling techniques [87].
  However, contracts will not only be autonomously created and implemented; already today advanced tools allow for predictive analytics, self-reporting monitoring processes, automated alerts, 'smart' contract performance analysis, etc. Contract management thus will change its connotation: It will no longer denote management of the contract but management through, or even by, the contract. This potential, however, calls for integrated management systems which link in particular knowledge management, risk management, and corporate strategy.
- **Contract content** Automation also changes the content of contracts which increasingly aims at autonomous intra- and inter-organizational processes rather than at human behavior and decision-making. The contract's vulnerability to misinterpretation and thus its potential for conflict can be addressed by replacing contract-guided managerial decisions by software algorithms. Smart contracts provide fast and unambiguous proceedings, reduce or exclude the need for human interaction, and increase flexibility in the management of a transaction. Thus some of the contract's traditional provisions will disappear since technology can manage the underlying issues as well ([88], p. 30), as we can already see from automated SLA (Service Level Agreement) management; others will lose in importance and, consequently, in contractual relevance because smart contracts can exclude certain manifestations of breach of contract ([89], pp. 130–131) or autonomously implement remedies, for instance for default of payment.
- **Contract presentation** The advancement of 'smart agents' will also bring about changes regarding the contract's visual and linguistic appearance, i.e. its layout, structure, language, and visualization. If business is performed on the basis of machine readable contract templates embedded in smart contracts, many of today's shortcomings in the 'ergonomics of contract' will become obsolete. On the other hand, however, the human user of the contract will have to cope with reading software codes, which may challenge the legal validity of smart contracts ([90], pp. 37 et seq.; [91], pp. 12 et seq.).
- **Contract functions** The enterprise of the future will rely on fully digitized and integrated business processes. This includes contract handling and will permit much better deployment of the contract to govern a relationship and to support the respective management processes as it does today. Besides the new alignment of the contract already discussed under 1.2.3.1.2, it is the expansion of its management capacities

through the developments of ICT (Information and Communication Technology) that calls for a new role of the contract: the transition from a provider of legal security to an enabler of business opportunities. As Jacob, Global VP of SAP, puts it:

> "Now, by using solutions like SAP S/4HANA for legal content with central content management, assembly and analytics functionality, and by integrating strategy, audit, tax, controlling, and project management information and other forms of legal content, all parties working at a deal, …, can collaborate to create better contracts, not just faster and more secure ones. We are moving from a paradigm of security to one of opportunity." [66]

The concept of contract lifecycle management doesn't meet today's management needs, as seen above. Considering the ongoing developments in technology, business, and process design, it will be even less capable of satisfying the requirements of the future. The challenges ahead can only be matched if there is a concept at hand which ensures a full-fledged use of the contract's management potentials as well as optimal support processes for contract handling.

1.4 Contractual Management Approach and Model

Based on the preceding analysis, this section proposes a reorientation of the deployment of contracts in business. It introduces the Contractual Management Approach which understands the contract as an instrument of management and the Contractual Management Model which serves to operationalize this approach. Subsequently, it demonstrates how the Contractual Management Model and the Contractual Management Approach can be applied as a guideline for any contract-related managerial decision-making. The final discussion of the benefits and limitations of the model allows for an assessment of its worth in business practice and the ways in which it can improve the current shortcomings in contract usage.

1.4.1 Goals and Purposes

In this section, the Contractual Management Approach (CM Approach) is introduced as well as the Contractual Management Model (CM Model) derived from it. The **goal of both**, the CM Approach as well as the CM Model, is to make better use of the inherent potential of the contract to steer enterprises and business relationships. The CM Approach is based on a fundamental change in perspective, which allows for an understanding of the contract—its effects, handling, and the conditions of target achievement—from the point of view of the 'manager'. Thus, the company is interpreted through the view of the contract and, likewise, the contract is interpreted through the view of the company. For this purpose, the contract is released from its legal ties (preconditions, effects, methodology, language, etc.) and is considered in light of the opportunities it provides and of the requirements that need to be met when it is deployed by a company. The result

is a holistic, transdisciplinary understanding of the contract which makes possible a more effective use within a business context.

A primary goal of the CM Approach is therefore to make the contract more understandable and graspable for those concerned with its use—in the context of a business this would be the manager. Such users will then be able to perceive the contract as a phenomenon with economic, legal, organizational, and, if applicable, technical dimensions. They will realize that the contract is not the primary responsibility of the legal department, the lawyers, or the courts, but instead the responsibility of the management.

The CM Approach can be used for the purpose of answering contract-related questions from a business point of view. It enables an analysis and structuring of decision scenarios by identifying all relevant aspects to be considered, aligning them with the given company processes and assessing them according corporate decision criteria. By this means, all content-related aspects, proceedings, and structures can be established and analysed in order to find the optimal solution.

The CM Approach can also be used to teach legal topics from a management perspective, so that legal contents are perceived and processed as microeconomic information. Likewise, it can serve to translate business-related decision criteria and processes into legal concepts.

1.4.2 Terms and Concepts

Contractual Management denotes an understanding and usage of the contract in such a way that the full impact potential of a contract on an enterprise comes into effect.

Contractual Management must be **distinguished from contract management**. The latter captures the contract throughout its entire life cycle and subjects it to systematic management. Its key objective thus is the management of the contract. Contractual Management, in contrast, is concerned with management through the help of the contract by using it to aid an enterprise, business unit, transaction or business cooperation in achieving its goals. It therefore perceives and operationalizes the contract as a means of management.

The **Contractual Management Model** covers all tasks of a contract within a company as well as all management processes required for its use and aligns them towards the relevant subjects of management—the enterprise, business unit, and business relationship.

1.4.3 The Contractual Management Approach

Contractual Management designates an approach that instrumentalizes the contract to achieve managerial objectives. It is characterized by three features of contract handling:

1. The contract is perceived and used as a management device;
2. The contract is captured throughout the entire cycle of its management activities;
3. Contract-related processes are fully integrated into the management systems of the enterprise.

These dimensions will be outlined in the following sub-sections.

1.4.3.1 Contract as a Management Device

1.4.3.1.1 External and Internal Management Functions

The CM Approach understands and uses the contract as a program of action to which both business partners agree in order to realize a joint undertaking and which they consider to be legally binding. This program of action has both external and internal impacts. Externally, it determines the behaviour of the contractual partners insofar as it is significant for the overall success of the undertaking; in other words, it specifies management decisions affecting the contractual partner. Internally, the program maps the internal actions of the parties and thus ensures that they meet their obligations.

Through the terms of payment, for example, the contract has a direct effect on the supplier's cash management (internally), just as it triggers the transfer of the purchaser's payment (externally). Thus, the contract is an instrument of cash flow management, but indirectly also of scheduling and quality management because the purchaser's release of payment depends on the fulfillment of the contractually defined time and quality requirements. Force Majeure clauses can also serve as an example. They will provide the manager guidance in conduct if a transaction is disrupted by an unforeseen event which is beyond the control of the contractual parties. From an external point of view, this relates to risk sharing as well as to procedures to be followed to coordinate the parties' responses to such event. To the same extent, such clauses shape the internal activities of each partner in order to be able to comply with the requirements stipulated by the respective clause. In this sense, the contract guides the corresponding reactive management decisions both internally and externally. The two examples of terms of payment and Force Majeure thus highlight that contract provisions comprise considerable management substance; legal enforceability is only one of their many capacities and recedes behind management considerations as long as there is no dispute.

1.4.3.1.2 External Management and Mandatory Law

The contract's potential as a management instrument is limited by mandatory law which requires or prohibits certain actions and grants or excludes certain claims. The more a relationship is governed by mandatory law, the less the contract can unfold its management potential. In the member states of the European Union, for instance, the domestic law of the member states based on European consumer protection law grants the consumer the right to cancel a contract within fourteen days without giving any reason. The contract in this respect cannot allow for a contravening action of the company, even if both contractual parties agreed on it. However, the contract can stipulate farther-reaching rights of the consumer such as an extended cancellation period or a full coverage of shipping costs and insofar serve as an instrument to manage the business-consumer relationship.

It must be further stressed that in business practice, in particular in B2B, many contracts deliberately contravene mandatory law because the party drafting the contract

expects the aggrieved party to comply with the unlawful provision due to a lack of knowledge, fear of loss of reputation, the other party's superior market power or for other reasons. Thus, the contract's management potential will increase if there is a certain probability that a position stipulated by mandatory law will not be enforced.

1.4.3.2 The Contractual Management Cycle

During the transactional processing, the contract is used at different times for a variety of management purposes. Every managerial decision affects the decisions to be made in subsequent development stages, just as these can in turn have an impact on the previous stages. Contractual management therefore must be understood as a closed cycle.

As shown in Fig. 1.2, the **Contractual Management cycle** consists of five CM process steps: plan, draft, implement, monitor, and evaluate. They represent management activities executed or supported through the contract and distinguish themselves from the phases of contract lifecycle management, which systematize the management of the

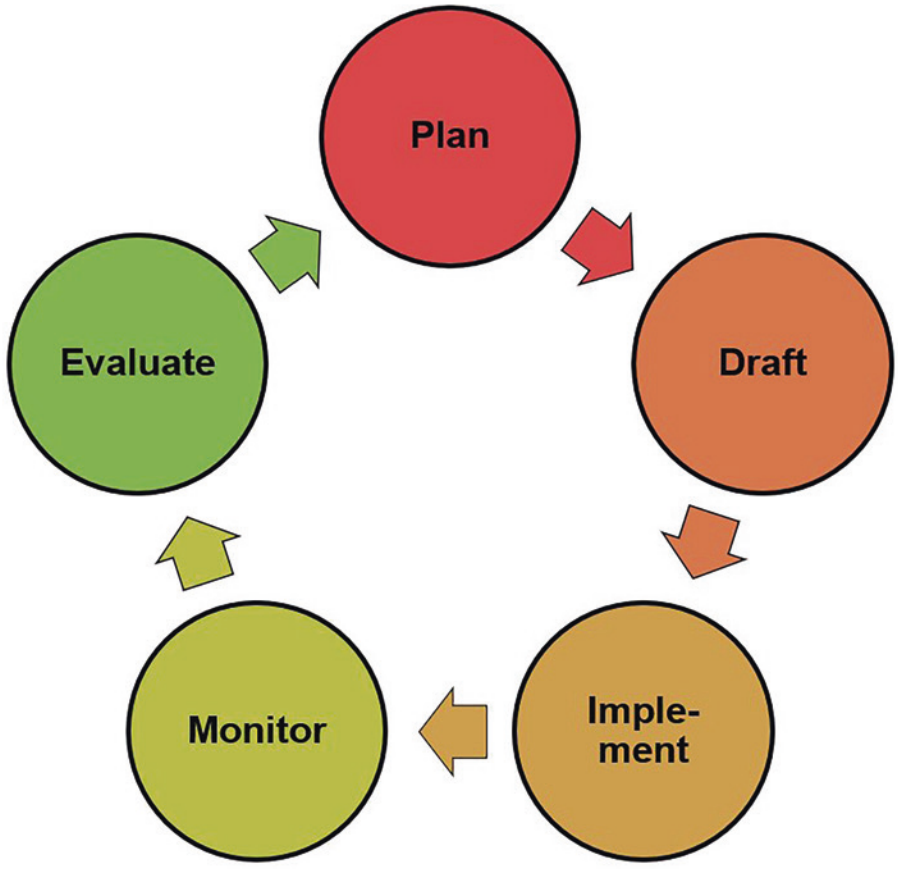

Fig. 1.2 Contractual Management cycle

contract. Each of the CM process steps is described in more detail in Sects. 1.4.3.2.1 through 1.4.3.2.5.

1.4.3.2.1 Plan

In his standard reference on contract management, Heussen ([75], p. 26; [76], p. 41) bemoans that contracts are only seldomly planned. This statement however must be put into perspective in two respects: Planning decisions for the usage of contracts are frequently made, albeit not always comprehensively and in a structured process. In addition, it is far from clear what should be understood under the term contract planning and how it should be distinguished from the implementation of the plan—that is, the drafting of the contract.

For complex transactions, numerous questions must be answered before the drafting of a contract can start, in particular:

- Will the task be split and if yes, how often and where?
- Will the outsourcing be horizontal or vertical?
  - If it is vertical: which procurement method will be chosen, e.g. design build, reimbursable contract, fast tracking, etc.?
  - If it is horizontal: will it be a cooperation or an association? If it is an association, will it be a joint-venture, or a consortium? If it is a consortium, will it be a silent or open consortium?

- Which contractual partner is strategically acceptable?
- Is it suitable to diverge from the minimum requirements?
- Which of the partners will draft the contract? Which standard contract will be used for the drafting? Are any ancillary documents (Lol, NDA, etc.) required?
- How will the contract negotiations be organized?

These and similar planning decisions provide the framework for the actual contract design, and yet the line of separation between planning and drafting can vary greatly depending on the particular transaction and company.

In high volume business, on the other hand, many decisions that would be assigned to the CM process step draft for complex transactions will fall under the strategic process step plan. This applies in particular to the deployment of general terms and conditions: for example, whereas in a complex transaction a contractual penalty clause will be negotiated and thus be part of the process step draft, it must be assigned to the CM process step plan if it is stipulated in the general terms and conditions.

1.4.3.2.2 Draft

As seen, the CM process step draft develops fluidly out of the contract planning. It realizes the framework developed during the process step plan by considering the concrete conditions of the given transaction, and it ends either upon contract award, rejection of the contract offer, or discontinuation of contract negotiations.

With regard to the CM process step draft, the contract's (commercial, legal, and product-specific) substance and (linguistic, structural, and visual) presentation have to be distinguished from the procedures it establishes. Internally, the latter refer to the defined processes, responsibilities, approval and authorization requirements, etc., whereas externally, they comprise the negotiations between the parties, in particular.

Contracts are generally drafted based on a standard contract, that is, a template universally applicable to a typical transaction of a specific kind. While the selection of the standard contract takes place in the process step plan, its adaptation to the specific conditions of the particular transaction—in effect the customization of the contract—is done during the process step draft. Depending on the degree of individualization of the transaction, the necessity of customization may vary: for high volume business, it normally requires only insertion of the contractual partners' data as well as the type, scope, time frame, and price of the services under consideration.

However, the more the conditions of the transaction at hand differ from those underlying the standard contract, the more the contract must be customized. Risk management may help to determine such deviations. It can serve to identify and to assess the risks of the particular transaction as well as to establish the measures required for risk mitigation via a risk response plan. To some extent, such risk responses must be implemented through the contract, for instance through contractual risk allocation (e.g. a limitation of liability), monitoring mechanisms (e.g. inspection rights), and instruments of intervention (e.g. the right to terminate). Although not all risks need to be dealt with by the contract, it may be a significant number depending on the type of transaction. The risk response plan thus highlights the necessary adaptations in respect of the template, but also the priorities of the issues to be treated as well as acceptable alternatives for problem-solving. Thus, it can be used to create an agenda for the negotiations, which enables a structured and coordinated pursuit of the goals that have been rationally, i.e. systematically and transparently determined and strikes a balance between legal and business requirements.

1.4.3.2.3 Implement

During the CM process step implement, two programs that will be discussed later under Sect. 1.4.3.3.1 c. are put into action: performance planning and risk. Both cover the rights and obligations of each party as well as the defined procedures and substantive decision-making criteria. Managerial decisions must be made according to these

programs. Because the contract has not only an external but also an internal impact, it also determines intra-firm procedures and therefore must be implemented internally as well. The performance planning side of a contract, for example, determines when a delivery or a payment will take place, and its risk prevention side specifies how a defect must be identified, notified, and rectified as well as how a defect affects the payment due.

Such implementation of the contract occurs through the close interplay of legal provisions, social norms, the interests of the actors involved, and the requirements of the transaction. Contracts are therefore not always—if this ever was the case—implemented according to the wording or the initial business intentions of the parties but are partially ignored or modified in light of unforeseen events or changed business interests; in other words, the contract is not the sole parameter for doing business, but just one among others.

1.4.3.2.4 Monitor

During monitoring, the contract reveals its management function by serving as a reference framework for keeping track of the execution of the transaction according to plan and to further develop the plan in case of actual changes. A comparison of planned/actual performance data allows for monitoring the factors that determine the success of the transaction, e.g. cost, time, quality, stakeholder response, etc. In this way, the contract paves the way for any necessary managerial interventions during the transaction process.

The CM process step monitor demonstrates to a significant extent that the enterprise and transaction goals can hardly be realized if the contract preparation (plan and draft) is not sufficiently integrated into the enterprise's management processes. Without an identification and analysis of the relevant risks and without the mapping of the resulting risk responses onto the contract draft, the management of a transaction will generally not be possible to the extent required. Quality control, for example, necessitates that the quality requirements of the customer as well as the corresponding test criteria and procedures were laid out in the contract. Furthermore, the contract draft must reveal how to put the risk treatment plan into action, which means that it has to identify the appropriate proactive and reactive tools geared towards a possible quality deficit (e.g. a subsequent performance). In this sense, the CM process step monitor is linked back with the CM process step implement or, in the case of any necessary changes to the contract, with the CM process step draft.

Since the contract is commonly perceived as an external instrument, it should be stressed again that it is equally effective as a device of internal monitoring in order to guarantee the realization of the transaction plan. This entails not only the typical controlling tasks but also others such as quality control, schedule control, or compliance management, the latter ensuring that enterprise interests are protected during contract initiation, conclusion, and execution.

1.4.3.2.5 Evaluate

The CM process step evaluate refers to the performance of the contract with relation to the established transaction and business goals. It takes place after the completion of the transaction and assesses the handling of the contract during the four previous CM

process steps—plan, draft, implement, and monitor—as well as the results it achieved. This means that, first, all data that may possibly be relevant for future transactions must be fed into in the internal knowledge management system. Followed by a review as to whether there is any need for optimization, this may lead to adjustments in contracting strategies, the standard contracts, minimum requirements, risk check lists, and procedural organization. The contract's contribution to this process step consists foremost in the provision of measurement parameters defined during the CM process step plan which now allow the assessment of the contract's achievements.

1.4.3.3 Integration of Contract-Related Management Processes

In order to be able to optimally use the full management potential of the contract, all its related processes—those that ensure the use of the contract as well as those that require support from the contract—must be linked with one another and integrated into the management systems of the enterprise. This requires charting all relevant fields of management (Sect. 1.4.3.3.1) and examining their structural intertwining (Sect. 1.4.3.3.2).

1.4.3.3.1 Relevant Management Fields

Scientific knowledge of the functions and purposes of the contract (see Sect. 1.2.2.2) and the inventory of contract-related management processes (see Sect. 1.2.3.3.1) both reveal that, in an enterprise, the contract affects four major management fields:

- corporate management (a)
- management of relationship (b)
- risk management (c) and
- knowledge management (d)

The contract exclusively impacts these four fields of management, or in other words, they entirely encompass all contract-related activities in an enterprise.

(a) In respect of contracts, **corporate management** defines the corridors of decision-making with regard to relationships, i.e. transaction and business cooperation, and the respective operative sequences. It processes external and internal requirements, i.e. from market or of mandatory law, which it transforms into internally binding norms, processes and structures or into decisions. As part of corporate management, compliance management serves to ensure internal adherence to such rules and decisions, and thus highlights possible conflicts between corporate goals and personal preferences as well as lack of knowledge or awareness. Other contract-related management processes which form part of corporate management are addressed separately under risk management (c) and knowledge management (d).

(b) **Management of relationship**: The term should not be confused with relationship management. Management of relationship is deployed here to designate the

management of the external relationships of an enterprise based on contracts. It thus covers the **management of the single transaction** as well as the **management of a business cooperation**, for instance a joint venture, consortium, virtual enterprise, etc. In this sense, it corresponds with the dichotomous classification of contracts into the association contracts and the exchange contracts. Relationship management, in contrast, aims at the creation of a positive and lasting relationship which is beneficial for both partners and thus beyond the single transaction ([40], pp. 57 et seq.), although it can include transactional activities in contract negotiations or dispute resolution.

As already seen above, there is no general concept addressing the management of a transaction. However, since the contract is one of the main sources of transaction-related management activities, a consistent designation is required to address contract handling in a comprehensive manner. It seems suitable to use the term **management of transaction** for this purpose.

Association contracts do not address transactions but the organization of joint and coordinated efforts in business. Since they create and support a common governance structure, they make different demands on contract handling than exchange contracts. Association contracts, however, are largely outside the focus of contract management literature despite their crucial role for the governance of a business cooperation. In business informatics, for instance, the contract is considered to be the main steering instrument for virtual enterprises ([88], p. 31; [1], p. 111). This is why the management of business cooperations is given particular attention here.

(c) **Risk management**: Today, the risk dimension of the contract is understood dynamically, i.e. from the management point of view. Accordingly, the contract is considered relevant for risk management in two respects: as a source of risk and as a risk treatment device ([92]; [42]; [45]). Its identification as source of risk is assumed a priori, yet a theoretical foundation for this assumption is missing. The authors Schuhmann and Eichhorn have tried to shed some light on this issue in a previous work [58]. In contrast to the contract's first contribution to risk management, various academic disciplines agree on its role as risk treatment device: Contract theory primarily considers the contract in respect of its function to share risk [93]; the economic analysis of law theory emphasizes its role in risk allocation and protection from opportunistic behavior ([94–95]), the latter also being a source of risk [96]; legal sciences view the drafting of contracts as a precaution for the future [97–98] which is characterized by uncertainty; and, finally, the preventive law theory in respect of the contract focuses primarily on the anticipation of, and provision for, risk [99] as does the proactive law approach [24].

Since the 1970s, legal sciences have increasingly been exploring the risk dimension of the contract. Following Macneil [100], they recognize that the contract captures two subject matters of regulation—performance planning and risk planning. This means that it specifies both the obligations each party must fulfill as well as the actions they may take in the case of events which hamper successful execution.

However, several authors concede that a clear distinction between the two regulatory dimensions can hardly be achieved [98]. As a matter of fact, the concept of risk

perfuses far into the performance planning processes and various scholars show that most, if not all, provisions in a contract have a risk dimension ([101]; [24]). This shall be demonstrated by the example of long-term contracts. Their subjects of regulation are categorized according to different criteria (see e.g. [36, 102]), but can roughly be assigned to four areas: (1) contractual performances (obligation and counter-obligation), (2) uncertainty (impediments to performance and environmental impact), (3) cooperation (procedural processes) and (4) general conditions (formal requirements, contract language, choice of law, etc.). The legal sciences have always assigned the domain of uncertainty (2) to risk planning ([100]; [98]). It is also evident that within the domain of cooperation (3), the behavior of contractual partners can be deemed as risk to the transaction success if an act of collaboration by the partner is required. But even the core area of transactions—contractual performances (2)—can be comprehended through the construct 'risk' to a large extent. The decisions for a procurement strategy ([103–104]), the chosen performance description, the type of pricing ([24], p. 81), or the terms of payment [104] all arise from a risk-opportunity trade-off consideration. Finally, the subjects of regulation commonly attributed to the general conditions (4) can be encompassed through the concept of risk, too (take e.g. the choice of law). All this shows that the content of a contract can—with the exception of type and scope of performance—be grasped through a risk assessment.

Nevertheless, there are objections to a strong emphasis on the construct 'risk' in business. In particular in relation to transactions and contract, risk has a negative connotation since it is associated with unbalanced risk allocation and an adversarial mindset. However, as long as management assesses business ventures in terms of risk and maintains sophisticated risk management systems, it seems appropriate to make use of such already existing concepts and devices. This is all the more valid since opportunity management, as considered by some authors, does not provide an operational approach that goes beyond risk management. The deployment of the construct 'risk' in any case should not produce negative effects as long as it does not happen in an adversarial and protective attitude.

(d) **Knowledge management**: An adequately designed knowledge management system serves as a link between the different contract-related management processes and extents to all relevant subjects of management, in particular to enterprise, business cooperation, and transaction. Two dimensions can be distinguished in this respect ([63], p. 43): Its **input dimension** refers to the activities involved in order to systematically identify, acquire, develop, and evaluate the requisite knowledge. Thus, all data filed in the contract as well as any data collected during the acquisition, planning, negotiation, execution, and evaluation of a business deal must be fed into an integrated knowledge management system or at least into interconnected sub-systems. Its **output dimension** has a process-oriented and supportive function. Process-oriented tasks serve to supply information so that the addressees can perform an analysis for a specific transaction or for strategic purposes, can make decisions, or implement measures. For example, during the CM process step draft,

knowledge may be made available about certain aspects, such as details on the contractual partner, the transaction type, the concrete business deal, and the framework conditions; or data relating to certain risks may be aggregated from the company's portfolio of contracts so that they can be used for reporting, strategic decision-making, or ERM. The second, supportive, function of knowledge management lies in the delivery of information in order to develop and update tools used for risk management and management of relationship purposes. Checklists, knowledge pools, sample contracts, decision trees, minimum requirements, etc. can thereby be matched in a timely and reliable manner with the latest developments, for example after the performance of the CM process step evaluate. AI-based contract analytics is about to revolutionize this field of management.

1.4.3.3.2 Integration Through Risk and Knowledge Management

Risk and knowledge management are supportive, cross-sectoral management processes. They involve a large number of the management activities in an enterprise and thus can serve to connect all contract-related management processes. This integrative function is depicted in Fig. 1.3.

As explained in Sect. 1.4.3.3.1, the construct 'risk' can be used as a lens for capturing the regulatory substance of most, if not all, provisions of the contract. Consequently, risk management can link such provisions with the needs of both, the management of relationship and corporate management. Knowledge management fulfils a similarly integrative task. It provides the data which are not typically subjected to risk management and insures that they are made available to the relevant functions in the enterprise.

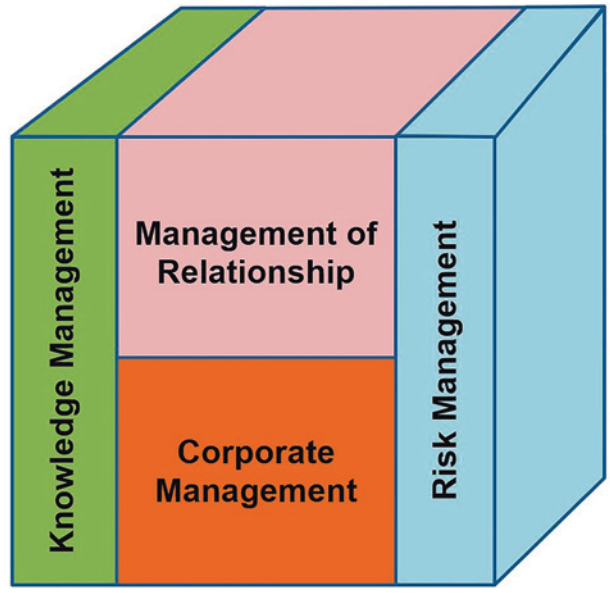

Fig. 1.3 Process integration through risk and knowledge management

Such data are extracted from the contracts or retrieved from other company or external sources, for instance the internet. Knowledge management furthermore extends to the IT-infrastructure needed for the exchange of data and information and which often shapes the management processes and increasingly works as a driver of integration.

1.4.4 The Contractual Management Model

For the operationalization of the CM Approach, three aspects of a goal-oriented contract deployment must be taken into account:

- Contract handling must be aligned with the **enterprise and the relationship targets**;
- All activities of contract deployment must be considered at any time; the resulting **Contractual Management cycle** encompasses the process steps plan, draft, implement, monitor, and evaluate;
- Decision-making must consider the requirements of the processes in four **fields of management**: knowledge management, risk management, corporate management, and management of relationship. These fields are largely interwoven and cover all contract-related processes.

The three aspects of contract deployment just mentioned constitute the CM Model. Since they refer to different classification criteria, they can also be designated as **the three dimensions of the CM Model**. The CM Model thus is based on an integration of all contract-related management processes in an enterprise and makes use of them for an optimal deployment of the contract, just as it uses such processes to ensure the achievement of enterprise and relationship targets. In this sense, the CM Model does not create an actual management process but superimposes a virtual process onto the enterprise's existing operations in risk management, management of relationships, knowledge management, and corporate management while seizing upon the relevant functions of each of these fields.

Figure 1.4 **visualizes the CM Model**. The three dimensions of the model suggest the use of a cube for its presentation. The right side of the cube displays the subjects of Contractual Management—relationship and enterprise. Its top shows the four fields of management—knowledge management, management of relationships, risk management, and corporate management—which encompass all contract-related management processes. The front of the cube portrays the five process steps of the Contractual Management cycle, which represents the main activities in contract handling targeted at the enterprise and the relationship as well as the interfaces to the various contract-related management processes. The first step and starting point is the planning of the contract (plan) which is a part of the development of the relationship and relies heavily on the plan of action that was developed within the framework of risk management. During the second process step (draft), this plan is realized through the drafting of the contract,

the negotiation of the drafts, and finally with the conclusion of the contract. In the third step (implement), the contract is executed via the application of its provisions in accordance with the transaction or cooperation requirements, as well as the company strategies. The fourth process step, monitor, records and evaluates the effectiveness of the managerial instruments laid down in the contract as well as any shifts in the risk situation that have taken place in the interim, which in turn allows for any necessary corrections to be made. The last process step (evaluate) analyses the performance of the contract and feeds the results into the relevant corporate processes, in particular knowledge and risk management.

1.4.5 Contractual Management Approach and Model in Managerial Decision-Making

1.4.5.1 Application of the Contractual Management Approach

The CM Approach offers a **change in perspective** towards the role of contracts in business: It creates the awareness that contracts are not primarily a legal but rather a managerial tool and therefore can and must be instrumentalized to govern the enterprise and the relationship, i.e. a transaction or a business cooperation. In consequence, the CM Approach will lead the user to the question of how the contract can contribute to change management, conflict management, information and communication management, enterprise network management, etc. To meet these managerial objectives, the contract must address the issues relevant for the manager and needs to be drafted in a way that the latter can understand and handle its content.

1.4.5.2 The Operation of the Contractual Management Model

The CM Model as visualized in Fig. 1.4 serves to enable the user to systematically approach any contract-related task arising in business practice. In addressing the model's three dimensions of Contractual Management, he or she will be guided towards all issues arising in connection with contracts.

(a) 1st dimension: subject of management
It is one of the main objectives of the CM Approach to provide for a better balance of **enterprise** goals and, in particular, transaction requirements. The line manager therefore has to plan the contract in accordance with the established enterprise goals and procedures and to execute the contract according to its content, whereas staff functions, in turn, have to consider the requirements of the operative business. Contract compliance, therefore, can only be effective if it doesn't work as a one-way road from the top down, but also encompasses procedures which provide for the transmission of crucial information relating to **relationships** into the strategic decision-making of the enterprise.

(b) 2nd dimension: Contractual Management cycle
This dimension of the CM Model reminds the user that when addressing any current issue, he or she must also take care of future needs with respect to contract handling.

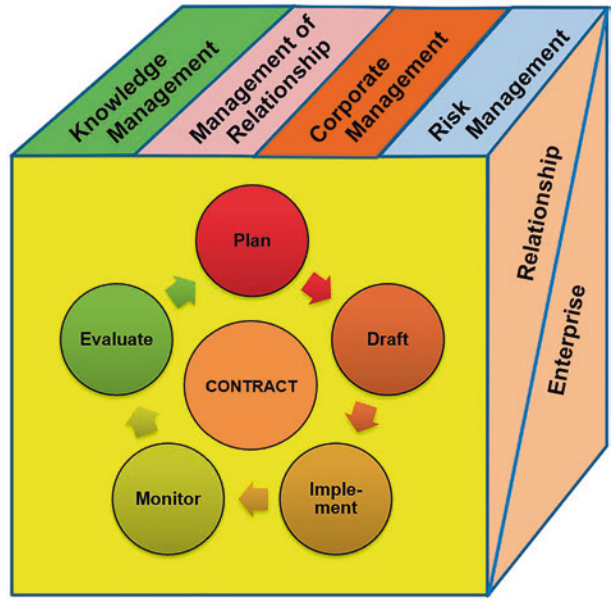

Fig. 1.4 Contractual Management Model

When drafting a contract, for instance, previous **planning** decisions as well as subsequent demands of contract **implementation** and **monitoring** must be considered. When appropriate, the **drafting** process must also be **evaluated** for relevant insights which may help to optimize the internal processes or provide valuable information for future transactions or business cooperations.

(c) 3rd dimension: management field
The CM Model guides the manager to consider four fields of management while dealing with his or her task**: knowledge management, management of relationship, corporate management**, and **risk management**. These fields encompass the usual processes which must be complied with for operational decision-making, and equally form the frame of reference for the development and optimization of enterprise processes which allow for a full use of the contract's management potential. Although each of these processes stresses particular aspects of the manager's task, they are closely and variously interwoven and thus, if organized well, provide a comprehensive and holistic system to handle contracts.

Addressing the requirements of each of these four fields of management will ensure that the decision-maker considers all contract-related aspects of contract handling:

- **Knowledge management** leads the manager to access all information and data needed for the decision-making, and to provide the information and data produced during this process for all enterprise functions which depend on such input. With respect to organization, these requirements call for adequate support from, and the actual usage of, a suitable IT-infrastructure as well as processes and tools.

- Keeping the demands of **risk management** in mind allows for a rational, transparent, and monitorable decision-making which fits into superordinate risk management considerations. In respect of the substance of the decision, it ensures that all relevant challenges encountered in the relationship have been addressed.
- Turning towards **corporate management**, the manager will face in particular the requirements of compliance management and thus of external and internal norms which limit his or her scope for decision-making in terms of substance as well as procedure. Compliance management will help to link and to streamline operational decision-making within its wider environment.
- **Management of relationship** highlights the immediate business context in which the decision-making takes place. Since such context will differ depending on the type of relationship, the perspective of this field of management of relationship supports the manager in identifying the specific conditions of the relationship he or she must consider in terms of goals, processes, and structures as well as how to handle them appropriately.

1.4.6 Novelties and Benefits of Contractual Management

The CM Approach and Model provide some new insights into the operational capabilities of a contract (Sect. 1.4.6.1). In practical application, they enable the user to recognize the management potential of contracts and to complement his or her skills and the instruments at hand to adequately address contract-related management issues (Sect. 1.4.6.2). Likewise, they bring about various positive impacts on contract handling in enterprises, as well as on management processes and practice in general (Sect. 1.4.6.3).

1.4.6.1 Novelties of Contractual Management

Contractual Management shows the way to the optimal deployment of contracts in business. Its elements are certainly not new; what is novel is that it amalgamates the various, in parts disparate and conflicting, concepts already in existence and thus produces a consistent system that ensures the best practical usability of contracts. This innovative leap hinges on a change in perception of the contract and its revised positioning within the management landscape of an enterprise:

New view towards the contract's purpose The contract is no longer perceived and used as a legal instrument providing security to a company, but as a management instrument geared towards actively realizing business opportunities. Consequentially,

- the contract becomes a matter of interest primarily for the manager and less for the lawyer, and
- the contract is not the subject of management but rather manages itself. Therefore, the cycle of Contractual Management activities is taken into consideration and not, as in contract management, the management of the contract throughout its lifecycle.

New positioning of the contract Contractual Management re-defines the position of the contract within the management landscape of an enterprise:

- It makes the contract the reference point for an independent management process which is completely integrated into the management systems of the enterprise;
- It emancipates management of the transaction, a field that suffers from severe conceptual underdevelopment, and puts it on equal footing with corporate management;
- It places risk management and knowledge management in the center of all contract-related activities; both cross-sectoral processes deliver the parameters, infrastructure, and substance for decision-making with respect to contracts.

1.4.6.2 Benefit for the User

The CM Approach is equally viable in teaching as it is in practice. It allows the user to fully deploy the inherent management potential of a contract through an enhanced understanding of the contract as well as improved skills and additional tools for handling the contract and organizing its working conditions.

New understanding The CM Approach explains management from the point of view of the contract just as it interprets the contract from the point of view of management. Thus, management challenges become contract issues and vice versa, and the line between law and business is a permeable one. In consequence, the lawyer will understand the business implications of a contract and the resulting requirements for contract design and handling, just as the legal layman will comprehend the business substance of a contract behind its legal appearance and therefore be willing and able to make use of its decision parameters and processes.

New tools or usage for new purposes In applying the CM Model, the user will, for instance, realize the importance of traditional risk management instruments such as risk checklists or risk response plans for contract drafting, or of business intelligence for contract planning and the development of contract templates. Most of all, he or she will discover that the contract itself is a management tool that can be deployed to support the achievement of enterprise and relationship goals as well as to streamline intra- and inter-firm communication and management processes.

New skills Contractual Management enhances the development of novel capabilities in designing and organizing contract-related management processes, identifying and applying parameters and processes for decision-making on which the parties have agreed as well as participating in the planning and drafting of contracts.

1.4.6.3 Benefit for the Enterprise

The implementation of the CM Approach can trigger a significant positive impact on the attitude of the management, contract quality, contract compliance, and contract handling as well as on the management performance in general. Four major advantages become apparent:

Better usage of contract Contractual Management discharges the contract from its legal connotations which outside the legal profession usually produce a negative attitude. Such a change in the perception of the contract

- enhances its acceptance by non-lawyers and hereby fosters its informational and instrumental usage; it further
- allows for a comprehensive alignment with business considerations and thus increases its compatibility with economic thinking patterns and facilitates its docking to the enterprise's management systems.

Higher contract effectivity As a goal-oriented concept, the CM Approach provides for a systematic contract handling based on specified performance criteria. They will

- guide the selection of the contract template and its customization,
- enable the measurement and assessment of contract performance, and
- allow for the monitoring of contract implementation and an intervention in cases of undesired developments.

Balanced transaction and enterprise objectives A stronger focus on the management of transaction aside from corporate management paves the way for a better positioning of contract handling in respect of the frequently diverging requirements of transaction and enterprise. Such a shift in emphasis will reduce non-compliance with the contract and the internally binding provisions and enhance information disclosure and transparency.

Optimized management processes The integration of all contract-related management processes will bring about positive effects in contract handling as well as management in general:

- It ensures that all data, information, and decision parameters laid down in the contract or collected during contract handling activities are fed into the relevant processes (information output) and that the information needed for the development and use of the contract is channeled into its handling processes (information input);
- It stimulates the matching and synchronization of processes and activities, whereby redundant work is avoided, and cross-functional communication is simplified.

1.4.7 Limitations of the Contractual Management Approach and Model

The CM Model claims to provide a comprehensive and holistic concept for the deployment of contracts in business. Therefore, the issue of its limitations resulting from deliberate design decisions arises. The operational scenario for which the model has been developed displays three features:

1. A management decision relating to a contract has to be made;
2. Decision-making is aligned with the objective of optimizing company interests: and
3. A well-developed management system is in place.

Since all of these features will only be given for activities of larger private sector companies, the question arises as to which extent the CM Model can be deployed if one of the features is not in place or is noticeably underdeveloped. The following considerations as well as some of the case studies presented in Part II of this book cautiously approach this issue, which still requires substantial research effort.

1.4.7.1 Non-contractual Management Issues

According to its deliberate focus, the CM Approach does not help to deal with management issues in general but only in those situations in which a contract-related decision must be made. If, however, a contract is involved in management activities, the 2nd dimension of the CM Model always fully applies, which means that all CM process steps according to the Contractual Management cycle must be considered because they are inherent aspects of contract handling and not factors depending on the field of application.

1.4.7.2 Cross-Company Subjects of Management

The CM Model follows the perspective of the manager who focuses on the interests of his or her employer. For exchange contracts like sales or service contracts, it will be applied twice: Each contractual party can use it for the optimization of its interests. However, two or more distinct business entities can also install an organizational framework of varying intensity such as an association (a), a contract network (b), or inter-firm management processes (c) to engage in activities they could not handle as efficiently alone as they could jointly with a partner. In such cases the issue of **cross-company Contractual Management** arises.

(a) The sciences deal with the steering function of contracts or with contract management primarily with respect to exchange contracts. If they consider these issues for **association contracts**, they usually do so for strategic alliances, for which they examine the same steering mechanisms and modes of action as they do for exchange contracts ([35]; [105]; [37]). In consequence, the CM Model must be equally suited for the handling of association contracts and does not show any essential particularities in this respect.
Figure 1.5 illustrates the deployment of the CM Approach in an association contract setting using the example of a project contract concluded between the owner and a consortium, a so-called open consortium.
In the operational scenario outlined in Fig. 1.5, the consortium contract is planned, designed, negotiated, executed, monitored, and finally evaluated by each of the consortium partners C_1–C_3 separately and according to its individual interest. Subjects

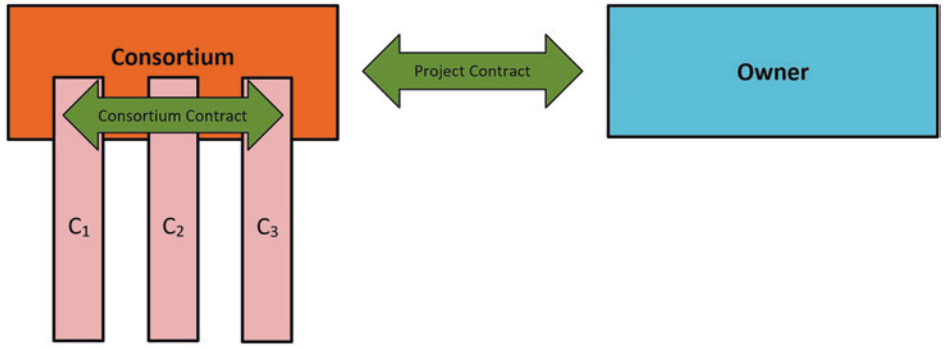

Fig. 1.5 Contract management in the context of an open consortium

of management for each consortium partner is its own enterprise and its relationship with the consortium partners. Likewise, the owner can use the CM Approach for achieving his goals regarding the project through the project contract which is an exchange contract. However, the consortium itself, as a contractual party of the project contract, cannot make use of the CM Approach. Although a consortium has a management, the consortium leader, it is not a subject of management of its own right but a vehicle through which the consortium partners realize their own interests. In fact, a consortium acts through its partners who use their own management systems to perform their individual workshare or to act as consortium leader. In particular, each of the partners will execute the various CM process steps with respect to the project contract for themselves and according to their own interests

The Oil Platform Case in Chap. 8 allows insights into the working of a project consortium.

(b) In contrast to the controversially discussed network contracts, **contract networks** represent a coordinated connection of single transactions as, for instance, encountered in supply chains. They raise the question of whether the different contractual relationships are isolated from each other, or whether an event affecting one contractual relationship can have a legal impact on others which form part of the network ([106], pp. 723 et seq.). Further examples include a main contract/sub-contract setting and a multi-contract research cooperation. The CM Model again cannot be applied to such a network as long as the latter is not perceived as a separate subject of management steered by means of a contract. Despite the fact that the interests of the contractual parties reach beyond their respective individual contract, it is this very contract that is designed and monitored by, and in the interest of, each of the parties; subjects of management are the enterprise and the respective contractual relationship as stipulated in the respective contract, but not the network itself.

The Contractual Sandwich Case in Chap. 6 highlights the impact of spill-over effects from a sub-contract on the main contract, and vice versa.

(c) The more a transaction requires collaboration of the contractual parties, the more management processes must spread across company limits in order to generate a partial, temporary integration. To this end, central communication platforms and inter-firm reporting systems are increasingly utilized, which in turn also calls for a uniform cross-company management of contract ([30], p. 94). **Inter-firm management processes,** however, do not alter the fact that each enterprise initiates, manages, and monitors the contract with regard to its own interests. In this case, the CM Model can only serve to identify the requirements of a joint management system.

1.4.7.3 Deviating Management Landscape

Contractual Management as a management-based approach and model largely relies on a well-developed management environment as it can be found in larger companies. To cast light on the usefulness of the CM Approach in case of deviating management conditions, three fields of interest displaying such particularities have been examined more closely through case studies in Part II: SMEs (a), the public sector (b), and society (b and c). Since the case studies undertake only limited and tentative explorations, further examination is required on these questions.

(a) **SMEs** commonly display less developed management structures as compared to larger business entities because they lack business skills as well as financial and staff resources. Still, they provide for the three dimensions of the CM Model: Relationship and enterprise are the subjects of management, and the contract-related management activities depict all CM process steps. Besides management of relationship and corporate management, risk management und knowledge management are of great importance albeit only rudimentarily mapped onto processes. Risk management, in particular, is recognized as a crucial field for SMEs, but it is mostly only practiced on a very basic level ([107], p. 125; [108], pp. 331–332). The same applies to knowledge management, notwithstanding the fact that it has to respond to different challenges in SMEs as compared to larger business entities. On the whole, it tends to be underdeveloped in SMEs and centered on the owner-manager who often forms a major bottleneck in communication processes ([109], p. 880). However, in the end it is not the size of a company but the scope and maturity of its management system which are decisive.

Even if it may not be appropriate to fully operationalize Contractual Management in a particular SME, it can nevertheless serve as a blueprint for the design and further development of contract-related management processes. A first and important step in this direction will be taken if the contract's management potential is understood and its handling integrated into the management landscape.

The Disclosure Backlash Case in Chap. 2, The Second-Hand Software Case in Chap. 3, and The Click and Wrap Case in Chap. 5 deal with the application of the CM Model in SMEs.

(b) With its increasing perception as a service provider, the **public sector** has come under the influence of management theory and has been dissociated from the traditional public administration model. Following the rise of the New Public Management (NPM) movement during the 1970s, more and more private sector concepts were transposed to the public sector ([110], pp. 6 et seq.), and terms like efficiency, target setting, performance, monitoring, and managerial authority came into focus ([111]; [55], p. 3). Since NPM understands the contract as a central instrument in the management of the public sector ([9], pp. 10, 147 et seq.; [55]), the resulting demand for an efficiency-oriented setting calls for a fully-fledged capture of all contract-related activities. The CM Approach can satisfy such a requirement. This is all the more true as various authors stress the need for contract management in PPPs and public procurement ([112], p. 268) just as for risk management [113] and knowledge management ([114], pp. 25 et seq.), which all constitute crucial elements of the CM Model.

Considering 'management' in the public sector, however, it must be taken into account that the public sector is ultimately bound by constitutions and public interests and therefore has different purposes and must meet other conditions than the private sector ([111], p. 1). In general terms, it has to respond to demands beyond profit maximization and efficiency; likewise, the public servant's role cannot be merged into that of a private sector manager. Therefore, NPM is understood today as an approach to drive efficiency into public administration but not to replace older frameworks of public administration ([9], p. 3), and its significance is declining again in favor of other concepts, for instance the public governance model ([110], pp. 18 et seq.). In an efficiency-oriented setting, however, Contractual Management can give orientation to the public sector even though it may require considerable adaptations depending on the given deployment scenario.

The Ultra-Long-Distance Energy Transmission Case in Chap. 7 and The PhilHeath Case in Chap. 11 provide deeper insights into the usage of contracts in the public sector as well as the conflict between the specifics of the public sector and management requirements.

(c) In the field of society, Contractual Management is also met with particular conditions. However, The Jamaica Coalition Case in Chap. 12 as well as Challenge 2 (Societal Perspective) of The PhilHealth Case in Sect. 11.6, underline that the CM Model may also be of use in this context. In particular, it can explain the transmission of internal parameters to external relationship building if it is used to identify the institution (instead of 'enterprise') and the relationship as the subjects of management and to delineate their ties. For the 'social contract', for instance, it will lead to society as the relevant institution and to the transaction by which services are provided to the citizens. Similarly, a political coalition contract can be explained through the institution (here: political party) and its relationship with another political party. The CM Model will furthermore underline that contract handling always comprises the same five CM process steps, notwithstanding the fact that in many

fields the focus is restricted only to a few of them. If there are limitations to the applicability of the CM Model, they will relate to the management processes which display specific features as, for example, 'political management' in the Jamaica Coalition Case or constitutional processes in the PhilHealth Case. On the other hand, risk-opportunity considerations and knowledge processing are crucial in any case. All in all, the extent to which the CM Model can mirror the conditions outside business seems to depend on the existence, orientation, and maturity of the contract handling processes.

1.5 Conclusions: Approaching from the Deployment Edge

This final section sums up the features of the CM Approach and the CM Model and highlights the benefits they may create for the management of a transaction, a business cooperation, and an enterprise. It illustrates how Contractual Management can realize a long overdue paradigm shift for making full use of the contract's potential in business.

The contract is an institution whose appearance changes with the purpose and conditions of its utilization just as it is perceived differently depending on the user perspective. It is important to accommodate this diversity, but it is equally crucial to recognize the **core substance of the institution** and its immutable working mechanisms. In order to identify the latter, a uniform starting point needs to be found from which all purposes and conditions of contract application can be assessed. To this end, the CM Approach uses the management function of the contract, i.e. its instrumentalization to achieve specified company goals. Conceptually, the approach is limited to application in business, and more precisely, to the usage of contracts for steering a transaction, a business cooperation, or the enterprise itself. The operationalization of this approach can be realized according to the CM Model.

Contractual Management interprets the contract not through the view of a specific scientific discipline, such as law or economics, but from the **perspective of the decision-maker** in a company who is the user of the contract, for instance in procurement, sales, or projects. Conceptually as well as content-wise, the CM Approach can therefore be considered as an approach of the applied sciences. As a management-focused concept, it differentiates itself from the contract-focused approaches which currently dominate practice in the form of contract management and, in particular, contract lifecycle management. In contrast to these, Contractual Management doesn't aim at the management of the contract, but instead at the management of the relationship and the enterprise. Hence, it is focused on the optimal orientation and handling of the contract in order to achieve the company goals, for which it provides a comprehensive model. Most importantly, it gives a new quality to the contract itself whereas contract management can only realize the inherent, i.e. the traditional capacity of a contract.

Contractual Management is an approach that regards the contract in its action mode. To this end, the CM Model addresses **three dimensions of contract handling**: It firstly

considers the contract's functions, i.e. the specific goals that the contract is intended to achieve. This 1st dimension reflects in particular that every contract has an external and an internal point of reference: the transaction and the business cooperation in the first case, and its own organization in the latter; both are interdependent. Secondly, the model captures contract handling as a management loop extending from contract planning and drafting through its implementation and monitoring up to evaluation (2nd dimension). These process steps need not follow the contract life cycle but may and must take intermediate or parallel steps; for instance, during implementation, the process can be referred back to draft or it can initiate evaluate. The Contractual Management cycle thus is liquid and may swiftly change directions. This implies that, while executing a contract-related task, the manager has to keep in mind the needs of other process steps as well as their possible contributions. In a 3rd dimension, the CM Model accesses all contract-related activities within four fields of management and integrates them into the enterprise's management landscape. Such bundling and integration are achieved through risk management and knowledge management which provide the necessary decision parameters as well as infrastructure and data input. Existing processes in the fields of management of relationship and corporate management are used to implement the respective measures.

The **practical benefit of Contractual Management** lies in a better use of the enterprise's contract portfolio through a different orientation of the contracts as well as their optimized handling. This is accomplished through the identification of legal as well as corporate goals relating to contract deployment along the same parameters (1st dimension). Furthermore, managers must be discouraged from considering any contract-related task in an ad hoc and piecemeal manner—for instance just concentrating on contract implementation—but to take into account all resulting requirements for current and future contract handling activities (2nd dimension). The integration of all contract-related processes into the management landscape of the enterprise (3rd dimensions) finally frees the contract as well as its handling from the isolation faced in enterprises and improves the quality of management processes in general. Thus, Contractual Management can offer a significantly better prospect than contract management to cope with today's shortcomings and the challenges that the contract will have to cope with in a digitized future.

A cautious transposition of the CM Model to **contract handling outside enterprises** offers some clues that its three dimensions can also be encountered in such settings, at least in a rudimentary form. If a consumer engages with business, he or she will consider personal goals, preferences and possibilities (corresponding to enterprise, internal point of reference) and try to balance them with the requirements of the transaction (relationship, external point of reference). Obviously, he or she will not rely on defined management processes but, notwithstanding this, will need access to relevant knowledge and consider pros and cons (risk). If 'enterprise' as the subject of management is replaced with the broader term 'institution', the CM Model can also, at least in part, be transposed to the public sector because here again the starting point of the activities are the

rules binding the institution as well as its specified goals, both framing the maneuvering space for transactions and cooperations. Although the management fields common in the private sector are either not found here or are of a different character, managing knowledge and risks constitute a crucial aspect of decision-making in the public sector, just as much as the management functions of the contract have to be monitored throughout the entire life cycle of a transaction or a cooperation. Finally, there are indicators that the CM Model can even be useful if there is no contract in the legal sense, as in political agreements, for example, or if there is no contract in a conventional sense, for instance if a 'social contract' is considered.

Contractual Management, thus, offers an approach as well as a model allowing for competent decision-making in business based on contracts. Beyond the economics of the private sector, it can be helpful, at the very least, in highlighting the different working environments of contracts and systemizing the factors that are relevant to their effectiveness.

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Part II
Case Studies on Contractual Management

In this part of the book, the deployment, benefit and, where appropriate, applicability of the CM Model are highlighted by **11 case studies.** They either reflect the views and insights gathered by the authors in their respective fields of activity and represent modified cases from practice or are constructed on the basis of factual experiences. However, all names, organizations, products, and services portrayed in the first nine case studies are purely fictitious; no identification with actual names, organizations, products, and services is intended or should be inferred. The cases from outside the private sector, in particular, do not always match the editors' assessment of the applicability of the CM Model. Nevertheless, the editors consider it a valuable complement if the case studies reflect a differing perception and usage of the contract and hereby highlight the diversity of the phenomena of the contract and its fields of application.

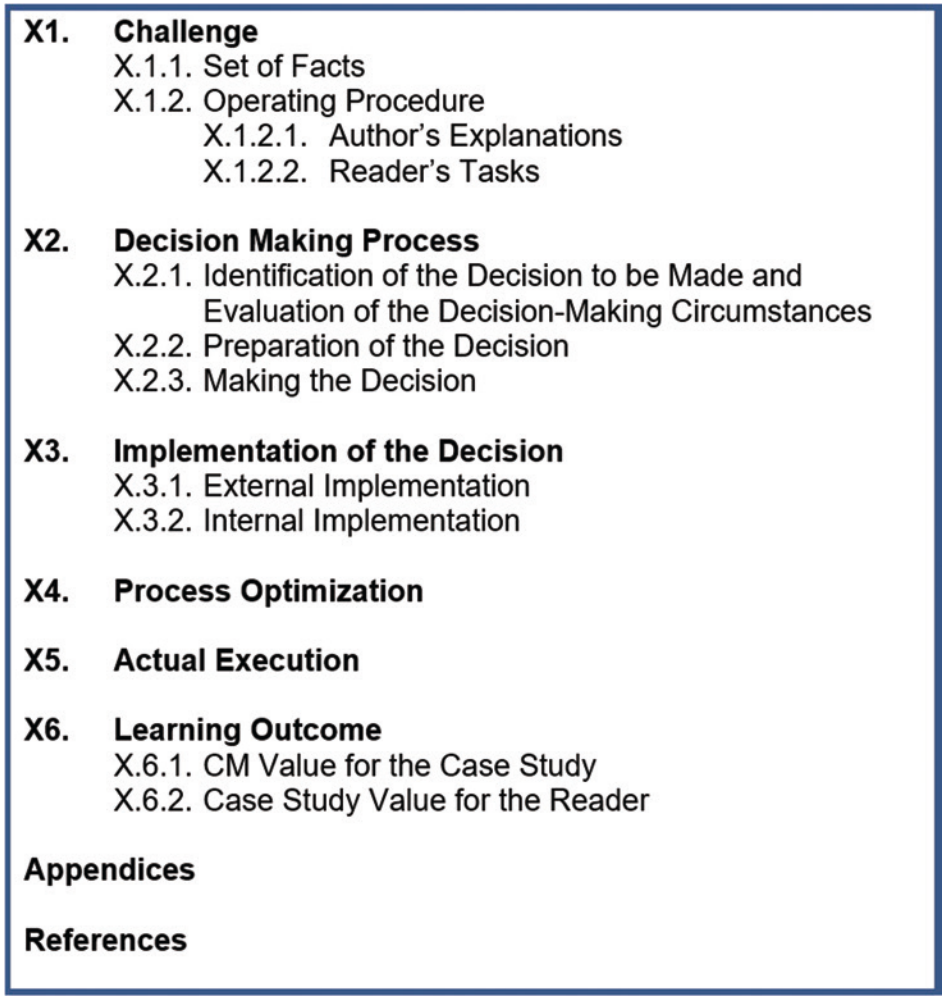
It is the **overall purpose of the case studies** to showcase the contract's role and potential as a management instrument in real-life scenarios. Thus, they do not address the management of the contract but instead highlight examples of management through the contract insofar as the latter steers, or supports the steering of, management processes related to an enterprise (organization) or relationship. Furthermore, the case studies serve to demonstrate how such an approach can be applied to specific decision-making situations by using the CM Model.

The **cases under consideration span across various principal management topics** in which the contract exerts a steering function. To highlight the range of the CM Approach, they deal with contract deployment in private, public, and public-private environments, in companies of different sizes, in business with and without customer involvement, as well as pertaining to different types of contracts and stages of contract handling. The features of the contract's application environment as addressed by the case studies are arranged in the **Matrix of Case Studies** in the Appendices at the end of the book.

According to the orientation of the CM Approach, the first nine case studies (chapters 2-10) can be grouped under topics reflecting crucial management issues: information and communication (Chap. 2 and 3), change (Chap. 4 and 5), enterprise networks (Chap. 6 and 7), conflict (Chap. 8), accounting & financing (Chap. 9), and legal compliance (Chap. 10). The ninth case study in Chap. 10 explores the contract's steering potential in fields that are affected by a large number of mandatory state laws. Case studies 10 and 11 can be grouped under societal steering (Chap. 11 and 12). They address constellations outside the business sector and explore which of the contract's effects unfold specifically in business and which also manifest themselves in other domains, such as—in these cases—in a social, public, or political context. The figure below displays management and other issues addressed by contracts as dealt with in the various case studies.

Management issues addressed by the case studies

Following the CM Approach, all case studies focus on situations in which a manager has to make a decision. To enhance the demonstration effect, they roughly adhere to the same rudimentary **structure template** which is displayed below:



Case study structure template

As already explained in the Reader's Guide, a perusal of the theory in Part I might be useful to look beyond the specific challenges in a particular scenario and to gain insights into the working of contracts in general. If the reader, however, prefers to immediately start with a case study in order to experience the CM Approach in action, he or she may at least consult Sect. 1.4.4 and 1.4.5 of Part I which explains the application of

the CM Approach and the CM Model. Otherwise, the following key system may provide guidance:

- **Institution**: Different kinds of organizations, e.g. private/public, profit/non-profit, large company/SME, will evoke specific challenges to contract-related management; in particular, the leeway for decision-making as well as type and design of management processes may differ.
- **Subject of management**: The contract is a tool for governing or supporting processes in enterprises. It has an external point of reference—the relationship, i.e. the transaction or business cooperation,—as well as an internal point of reference—the enterprise—which constitute the subjects of management.
- **CM process step**: Every management decision is made during a specific process step of the Contractual Management cycle—plan, draft, implement, monitor, evaluate. The manager must be aware that every measure taken in a specific CM process step may affect other process steps and that he or she must take precautions accordingly.
- **Management field**: All contract-related processes in an enterprise can be attributed to one or more of four management fields: knowledge management, risk management, corporate management, and management of relationship. Contractual Management makes use of the processes already existing in these fields and therefore works as an integral part of the enterprise's management systems. The resulting interconnection of contract-related processes allows for the much-needed flow of data into the relevant management processes just as such processes in turn provide information which is crucial for an appropriate handling of the contract.

  The four management fields cover all contract-related management processes, for instance management of relationship also includes project management, claims management, conflict management, etc., just as corporate management extends to compliance management and enterprise contract management. However, in order to more closely connect the case studies with business practice and thus to make them more accessible, reference is also made to these specific management processes in the information about the management fields relevant for the case study.
- **Contract type**: Each contract type, e.g. service contract, sales contract, association contract, captures the specific nature of the business and evokes typical issues. For management considerations, this is particularly true for contract meta data such as long-term/on-spot transaction, customized/bulk business, B2B/B2C/B2G, exchange/association relationship, etc. which figure as crucial working parameters for contract design and handling.

The Disclosure Backlash Case—Information Transparency in Effective Contractual Management

2

Ognyan Seizov and Alexander Wulf

Contents

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O. Seizov (✉) · A. Wulf
SRH Hochschule Berlin, Berlin, Germany
e-mail: ognyan.seizov@srh.de

A. Wulf
e-mail: contact@alexanderwulf.eu

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Abstract

This case study presents a problem which Internet-based companies often face, namely the fact that their terms of service are not sufficiently transparent. When customers fail to understand how a product or service is handled, a company is in a difficult position. On the one hand, it needs to preserve its business model which relies on the processing and sale of customer data to third parties. On the other, it has to improve disclosure practices to its clients if it wants to avoid extreme negative reactions among its customer base. Taking an Internet startup as an example, this case study demonstrates how the duty of Internet-based companies to inform their customers requires transparent information about both pre- and post-transactional processes. The case study implements all five steps of the CM Model and places special emphasis on knowledge management considerations as the best bringers of positive change in such circumstances.

Keywords	Online service provider, information obligation, transparency, privacy data handling, data valuation, customer satisfaction, information flow
Principle management topic	Information and communication
Institution	Internet startup, private, profit
Subject of management	Enterprise, transaction
CM process step	Plan, draft, implement, monitor, evaluate
Management field	Knowledge management, corporate management, information management, change management
Contract type	Service contract, data purchase contract

Editor's Note: For a full understanding of the CM Model's practical benefit for the case study, the reader may have to peruse at least sect. 1.4.4 and 1.4.5 of Part I. The keywords used above to characterize the area of contract application are explained in the key system preceding the case studies in Part II.

2.1 Challenge

2.1.1 Set of Facts

Psi UG, an Internet startup company registered in a Member State of the European Union and operating across the EU, specializes in providing individually tailored career and life coaching sessions. The company was founded in January 2017 and enjoyed a steep popularity curve thanks to an extensive online marketing campaign for its bespoke

life-improving and mind-expanding counseling sessions delivered by experienced coaches via live video chat at flexible hours. The first session is free, and subsequent appointments are priced competitively against traditional life coaching and career counseling price tags with additional incentives for long-term returning customers. Psi keeps its prices low by hiring recently retired counselors who are highly motivated and experienced. Trading in customer data is a major source of revenue and one of the driving forces behind the company's profitability and growth—a little over half a year into the business, the company has almost reached the EUR 2,000,000 revenue mark already. Upon registration, users provide demographic, occupational, financial, and basic medical information about themselves in order to facilitate optimal coaching session planning (see Appendix 6). The vast majority of Psi customers disclose these data readily because they value the company's service very highly, and the company's well-executed media campaigns have created sufficient trust that Psi will treat its users' information confidentially. Due to the detailed and sensitive nature of the data it collects, Psi UG has put a high price on its databases as a result of its internal **data valuation**. Companies from a variety of sectors (pharmaceutical, self-help, spiritual and occultist, etc.) are willing to pay for access to its treasure trove of information, which they employ for extensive and intrusive direct marketing campaigns.

Explanation: Data Valuation

Data valuation is the process of determining how much the data a company holds is worth. It is a relatively recent business challenge with a variety of approaches and no nominally right or wrong answers. The procedures employed to determine data value vary between business sectors, but some common considerations include the **strategic value** of customer data (in terms of hard currency and targeted product development), the **pairing of customer data with customer behavior** (i.e. data in real-time use), and the **data value prognosis** (i.e. how the current data valuation is likely to change in the foreseeable future). The depth and sensitivity of data are also crucial factors which usually push the price up. Digital businesses often collect and process customer information for their own benefit, and many choose to trade it to third parties for additional revenue. A company can put a price on its data holdings either internally or with the help of external data valuation experts. In the end, the value of such data is freely agreed upon by the two transaction partners at the time of the sale.

For **further reading** on data valuation and the processes and implications behind it, see [19]. For information on **EU legislation** concerning the definition, gathering, and processing of personal data, see Appendix 2: Extract from Directive 2002/58/EU and Appendix 3: Extract from Directive 95/46/EC.

It is now November 2017 and Psi UG has been riding a wave of high user acquisition and growing revenues, which are also bolstered by strong data brokerage sales. However, its success story is in jeopardy: Psi CEO Paula is becoming increasingly concerned that there will be a major backlash against her company's privacy policy and practices. It is

becoming apparent that the majority of Psi customers are not aware of the company's terms of service and privacy policy, which include an explicit (or so Paula thought) notice that Psi may process and pass on their personal information to third parties (see Appendix 1, 4 and 5). Clients who were initially satisfied now feel inundated by incessant targeted advertisements wherever they browse as well as by highly personalized emails. The content of those unwanted ads and their precise targeting point back to Psi. Customers are flooding the company's support channels, leaving angry messages, threatening legal action, and terminating their user accounts in waves. Paula faces the complex challenge of stopping the downward spiral of user exodus and negative feedback. She now has to tread the fine line between revising Psi's privacy policy to rebuild customer trust and ensuring understanding without turning too many customers away.

CEO Paula also has to take back some control of Psi's third-party data brokerage relationships without sacrificing lucrative data trading revenues. Even after Psi has successfully designed and implemented measures to reverse the customer exodus provoked by Psi's non-transparent contract terms, customers will still be averse to the amount of third-party advertising they receive as a result of using the service. This aversion will, in turn, be a major reason not to recommend Psi to others, depriving the company of a vital promotion channel. In view of these facts, Paula will have to explore her options to modify parts of her B2B contracts which regulate third-party actions with the data she is selling, with the specific intent of limiting the frequency of promotional campaign contact Psi customers receive. Here, the CEO will have to walk a tight rope and weigh both her legal and her practical negotiation strengths carefully in order to strike the right balance between customer and company interests.

Contract Knowledge: B2B vs. B2C Contracting

Business-to-consumer (B2C) standard form contracts differ from business-to-business (B2B) contracts in that the consumer will typically not have any influence on the content of the contract since it is usually dictated by the business's standard terms. Therefore, in B2C transactions, the consumer is regarded as the weaker contractual party, i.e. the one who has less information and less bargaining power than the business with whom the contract is being concluded. To strengthen the consumers' position in such transactions, B2C contracts are strictly regulated by the mandatory provisions of EU consumer protection laws and judicial clause control. In contrast, B2B contracts are typically less regulated, particularly if they were individually negotiated. Here only few mandatory provisions are applicable as the legislator deems businesses less vulnerable than consumers [22].

This case study, therefore, considers transparency as a feature of contracting with both B2C and B2B dimensions. The following sections present the problems, approaches, tasks, and solutions to both aspects in parallel in order to illustrate the interconnectedness of client- and business-facing efforts to increase transparency and improve information as an essential tenet of successful marketing, communication and customer relationship management.

2.1.2 Operating Procedure

2.1.2.1 Author's Explanations

The major problem covered by this case study arises in the **CM process step implement**, i.e., it is a consequence of executing the B2C and B2B contracts as drafted by Psi, accepted by its customers and by its third-party business clients, and concluded by each of the parties and Psi, respectively. The management activities required to solve the problem in both of its dimensions will, however, necessitate returning to the previous process steps **plan** and **draft**, a renewed stage of **implementation**, and increasing efforts to **monitor** and **evaluate** how the new contracts perform. Hence, the challenge extends over all five CM process steps and demonstrates the model's viability both as an analytical and as an actionable tool for improving management processes and solving managerial problems with the aid of improved contracting practices in two very different legal settings.

As she addresses the problem, Psi CEO Paula is guided or bound by (a) the laws and regulations of the European Union, which have been integrated into the national legislation of the Member State where Psi is located, (b) the current B2C contract which she has to honor while simultaneously improving its customer-facing transparency, (c) the B2B contracts she has with third-party data buyers, and (d) the usage statistics of her services which will inform her managerial actions much more strongly from now onwards. **Knowledge management** will thus be of utmost importance to Paula as she finds her way out of this conundrum. The CEO must address the general question as to how she can improve the transparency of her terms of service, privacy policy, and data brokerage contracts in such a way that her customers can understand what happens to their personal information and her business partners do not abuse the data they buy from her.

Answering the above question in a series of solution-oriented actions will, in turn, involve: (a) **corporate management**, i.e. CEO Paula must call together the board of her company and present the problem to them, task different personnel (e.g. IT, communication & PR, legal, etc.) with making the required changes, and also revisit her data brokerage agreements with third parties; (b) **change management** if the transparency-targeting improvements require revision of the current contractual formulations and actions, in both the B2C and the B2B case; (c) **information management** and **risk management**, where Psi's internal and external information flows will have to be subjected to much closer scrutiny and evaluation in order to foresee and prevent any future mishaps along the same lines. The contract remains the uniting factor throughout these different phases. Its role as a management tool is highlighted at each step, and the intricacies of amending and improving contract ancillaries such as the terms of service and the privacy policy are considered from the legal, business, and managerial perspectives.

Regarding more specifically the task of revising an existing B2B contract, this will be informed by **knowledge management**. **Change management** is the process by which the modification takes place, and its postulates stem from both the legal framework and the business culture of the sector. The ultimate decision will likely have long-lasting effects on Psi's business ties to other companies in the sector and will therefore involve

aspects of both **corporate management** and **risk management**. Finally, **information management** will be used to establish the extent of the modifications Paula will propose as well as every new data brokerage contract Psi concludes in the future in order to avoid new customer complaints.

In terms of CM process steps, the necessity for change arises at the **implementation** stage, and enacting a change brings us back to the **draft** stage, where the modifications must be negotiated and put into writing. Should change be negotiated successfully, the contract modification is followed by **implementation**, **monitoring**, and **evaluation** as in the main case study above. In a bid to avoid similar problems in the future, it is advisable to return all the way to **plan** in order to add a clause which protects Psi from such problems.

The central question the reader should consider here is whether the contract and the applicable regulations allow Psi to request and enforce a change to its existing B2B relationships. To determine this, CEO Paula must review the legal background and verify that the opportunity for change exists. She must then weigh up the business and cultural ramifications of requesting a change, strategize her negotiation tactic, and determine how hard she should press. In this endeavor, Paula must balance legal, financial, and personal relationships in a tightly knit business environment—a delicate and formidable challenge.

2.1.2.2 Reader's Tasks

Taking the perspective of Psi CEO Paula, the reader must consider the managerial processes described above and address the specific tasks enumerated below. To assist the reader in the decision-making process as well as to illustrate the chapter's learning objectives, passages from the relevant European directives and excerpts from Psi's information disclosures can be found in the 'Appendices'.

In this case study, the reader must assume the role of Psi CEO Paula and tackle the following tasks:

Task 1: Decide whether Psi should update its standard information disclosures in response to the customer backlash. (Level of difficulty: Low)
Task 2: Devise a plan for improving the transparency of Psi's terms of service and privacy policy. Any such plan should be based on knowledge both of Psi customers' behavior during contracting and of the state of the art of research on the subject of transparent disclosure. (Level of difficulty: High)
Task 3: Decide whether Psi can request a change to its existing B2B data brokerage agreements based on the texts of the contracts themselves and the prevailing business culture in the sector. If the request is possible, describe some of the risks it entails. (Level of difficulty: Medium)
Task 4: Once the B2B change request has been green-lit, determine the strength of Psi's negotiating power based on the value of the data it brokers and on the business setting where it operates. (Level of difficulty: High)
Task 5: Present the plan to the relevant company stakeholders (i.e. legal, communication & PR, web design & IT). After a discussion, distribute the specific tasks

and specify Psi's internal communication flows, which support monitoring and evaluation of the new measures. (Level of difficulty: Medium)
Task 6: Evaluate the efficacy of the measures implemented and determine whether further action needs to be taken. (Level of Difficulty: High)

2.2 Decision-Making Process

Task 1: Decision whether to Update the Disclosure Texts.
Psi's CEO Paula has already ascertained that an overwhelming portion of the company's customers find its data handling practices unacceptable enough to take active measures against it, including repeated contact with customer support and contract termination. The dissatisfaction spreads to social media and industry channels and actively damages Psi's initially good reputation. Before tackling this basic problem, however, Paula refreshes her knowledge of mandated disclosure as a concept and as a legal requirement in the EU.

Contract Knowledge: Information Obligations
Information obligations are part of the trader's duty to furnish the potential customer with all the details and ramifications of the impending contract before said contract is executed. They have become especially important in B2C contracting online, a setting in which consumers tend to be most vulnerable. They are buying a product which they have not yet seen or touched, or they are booking a service which they have not yet tested out. In their decision to enter the contract, customers rely on the clarity and completeness of the information provided by the trader. Lawmakers have therefore established an ever-growing battery of disclosure mandates which online businesses must meticulously fulfill in order to be in compliance and avoid legal difficulties. This tendency towards overexpansion is also the most frequently criticized quality of information obligations. Wherever they work, they are expanded to do more; wherever they fall short of their prescribed goal, they are expanded in order to reach it. The 'disclosure ratchet' [3] is leading to increasing burdens on businesses (in terms of compliance costs) and on consumers (in terms of the opportunity costs of getting oneself informed) and ultimately casts doubt on regulatory effectiveness of information obligations.

For **further reading** on the characteristics and challenges of information obligations, see [2, 6, 10, 16]. For an overview of information and party autonomy in EU contract law, see [9]. For samples of **EU legislation** on information obligations, see Appendix 1: Extract from Directive 2011/83/EU.

Legally speaking, Psi meets the requirements for information disclosure. There is a contract lawyer, Lars, who works with Psi regularly and drafts all legally binding texts. To date neither consumer protection authorities nor competitors, for instance, have filed any complaints against the company regarding its online services. In view of the time and resources Paula

has already dedicated to complying with the numerous disclosure mandates of the EU, it seems a poor choice to return to the drawing board and reformulate what is already in full harmony with the law. At the same time, exhaustive texts that comply with the letter of the law do not automatically translate into informed consumers. To add complexity and depth to her decision, Paula then considers the concept of transparency in information obligations.

Contract Knowledge: Transparency

Transparency is a crucial, if somewhat elusive, element addressed by the disclosure mandates of European law. As the duty to inform grows ever more comprehensive, the need for transparency also gains in importance. The high intensity and volume of customer-directed information in specific business sectors such as package travel or online trade have pushed the European legislator to also require that this information be presented clearly and comprehensibly. However, no specific transparency guidelines exist to date, and the lack of a uniform definition is one of the root causes of the shortcomings of information obligations as a regulatory mechanism. Because of the lack of specific guidelines for transparent information disclosure, the requirement is difficult to enforce and compliance hinges more on following the letter of the law than on ensuring understandability.

For **further reading** on transparent disclosure, see [11, 12].

Based on her review of the legislative and content characteristics of information obligations in the EU, the choices which Psi CEO Paula faces are relatively clear. Although the information provided by the company in its contracts is legally flawless, it remains inaccessible to her customers and thus proves ineffective in communicating with the average consumer. Additionally, during their angry interactions with customer support, many users confess that they have tried to read the privacy policy but gave up because it was too challenging. The discrepancy between legality and transparency is thus responsible for snowballing additional costs to her business, and urgent intervention is required. Paula therefore decides to initiate a revision and redrafting of Psi's terms of service and privacy policy, starting immediately.

Task 2: Plans to Improve the Transparency of Psi's Terms of Service and Privacy Policy.

Now that she has decided that a significant change is necessary, Psi CEO Paula is at the CM process step **plan** and faces the formidable task of directing this change. In the process, she has to maintain the integrity of the B2C contract on the one hand and ensure that Psi's business model continues to function satisfactorily on the other. Luckily, she has a strong battery of research results from diverse fields such as communication science, critical linguistics, and behavioral economics which can help her bring about positive change to the current situation.

Thus, Paula first turns her attention to insights from communication science, most of which focus on developing graphic design with a clear compartmentalization of information

[21], prominent attention guidance [13], presentation of important information in the form of graphics [17] or tables [15], and the use of the Internet's hyperlinking capabilities to create knowledge networks and hierarchies [4]. Although seemingly diverse, the findings point towards a need to organize information more clearly through prominent headings and subheadings which break down the text into palatable chunks. They also call for the most crucial information to be identified and presented in a graphically prominent format rather than being hidden in the plain text. Hyperlinks can be used to connect important sections of the text and provide definitions of important legal terms, relieving the customer of the need to search for explanations, connections or definitions on her own. During her review of the relevant findings of communication research, Paula is happy to note that the contract may require reformatting rather than rephrasing—i.e. small yet effective changes.

After considering contract form, Paula then turns her attention to content, with a special emphasis on language. Critical linguistics inform her that Psi's standard information texts, like those of many other contemporary companies, repel consumers with long sentences and legalese [1]. Furthermore, over-use of the passive voice and employing modal verbs such as "might" and "could," rhetorical questions, and persuasive appeals in privacy policies creates uncertainty and confusion as to what exactly happens to Psi customers' data, who sells and/or buys it, with what regularity such transactions occur, and, ultimately, what consequences they may have for the customers [18]. As she reads about the importance of language in presenting complex processes in a clear way, Paula is reminded of the power of the contract to manage not only transactions but also subjective expectations and even feelings such as trust or confidence, which are crucial for business success. While using fuzzy language has the advantage of alleviating customers' concerns about their personal data, the practice backfires massively when the false sense of security and privacy is shattered by targeted advertising from Psi's B2B data-buying partners. CEO Paula, therefore, decides that the privacy policy needs a linguistic overhaul. She plans to remove all language which creates uncertainty as to what happens to her clients' personal data, so that Psi's practice of selling it to third parties regularly becomes evident. This carries a risk of losing potential new customers, but Paula believes this prospect is less damaging than the status quo. She makes a mental note to discuss this point extensively at the company meeting later.

Lastly, Paula considers insights from behavioral economics, the field which combines aspects of social psychology and economics to study consumer actions and decision-making. In the context of terms and conditions, consumers prefer texts that are short and simple [6]. In one survey over half of the consumers responded that they skipped reading privacy policies altogether, with lack of readability as the major cause [7]. Literacy and language proficiency also play a role in the extent to which consumers engage with standard information online [14]. Armed with this knowledge, Paula briefly considers tasking Psi's copywriters and lawyers with shortening the terms of service and privacy policy considerably in order to make the text accessible and understandable to the widest possible audience. In this endeavor, she considers departing from the concept of **'average consumer'** as defined in European legislation, and focusing instead on a less experienced, more vulnerable consumer profile.

Contract Knowledge: Average Consumer

Court ruling C-210/96 of the European Court of Justice defines the **average consumer**, towards whom all European disclosure legislation is geared, as "reasonably well informed and reasonably observant and circumspect" [23]. Hence, in the eyes of the law he or she is a sophisticated person who is in a position to read and understand all standard information and to apply them in a logically sound decision-making process. The average consumer is conceptualized as the lowest common denominator and guides legislative development and formulation. Some critics argue that, thus defined, the concept sets an unrealistically high standard which does not correspond to reality; others insist that this is the most practical role model for developing legislation and that further reducing the presumed abilities would lead to standard information requirements becoming even more voluminous and numerous.

For **further reading** on the average consumer as defined in European legislation, see [5].

After this thorough overview of the problems related to B2C agreements, Psi's CEO turns her attention to the B2B agreements in order to ensure that her fight for greater consumer-facing transparency will also find support in the practices of her business partners.

Task 3: Determine whether Psi Can and Should Request a Change in the B2B Data Brokerage Contracts.

Change management is a powerful tool for dealing with unexpected post-contractual events and modifying the contract's management capabilities for unilateral and/or mutual benefit. When requesting and negotiating change, Paula has to take into account: (a) the current version of the B2B contract and the legal principle of honoring an already existing contract (or *pacta sunt servanda*); (b) the contracting parties' duty to cooperate, which deviates from the above principle in situations where one side needs the other's support to achieve a positive outcome; and (c) the non-legal arguments for and consequences of Psi requesting a change.

CEO Paula proceeds to pore over the contract, confirming that it does not contain any terms which explicitly allow Psi to change the conditions of the contract unilaterally. Under *pacta sunt servanda*, therefore, Psi must honor the contract as it stands and cannot unilaterally change it. Going back to the first process step of the CM Model, Paula makes a mental note to herself to speak to lawyer Lars (process step **plan**) and amend the contract (**draft**) for all future data brokerage agreements in order to safeguard Psi's reputation and revenue. Later on, Lars agrees to draft an additional contract clause to assert Psi's right to call for modification or termination of data brokerage agreements if the opposite side consistently strays from best promotional practices and in doing so damages Psi's good standing with its customers (**monitor** and **evaluate**).

Proceeding to duty to cooperate, Paula finds that the situation is not as clear-cut but still not too favorable for Psi. The duty to cooperate calls on both parties to remain flexible for the sake of completing the contract successfully. Since the contract in question concerns

the purchase of user data from Psi by third-parties and does not include requirements as to the frequency of use of such data post-contractually (an omission Paula and Lars made in the first stage of **planning**), Psi has, from a legal point of view, an unfavorable position in the upcoming renegotiations. However, a cooperation plea could support Paula's bargaining position when she approaches her business partners and lets them know that their spamming practices are hurting Psi, as her current efforts to **monitor** the contractual effects demonstrate. Worse yet, they also endanger its ability to continue providing them with high-quality user data. This **evaluation** leads us to the final aspect of Paula's decision, namely the cultural acceptability and business consequences of the proposed change. In the rapidly changing, analytics-driven world of online service trade, sudden shifts in consumer behavior and sentiment are commonplace. In this business context, Paula is in a good position to make an argument for enacting a limitation on the frequency of promotional messaging by third parties based on the compelling case that it is forcing Psi out of business and it is, thus, not in their partners' best interest to resist the change.

Based on the logic above, CEO Paula considers her potential request to be necessary and in line with the ethics and practices of her business environment. She then turns her attention to the specifics of the change she is about to request.

Task 4: Negotiating the Extent of Change.
After establishing Psi's weak legal but strong persuasive position for enacting a change in its data brokerage agreements that, taken as a whole, is only minor, CEO Paula has to decide how extensive this change request ought to be. The following are some important factors which lend Psi negotiating strength, in descending order of importance.

- The quality of the personal data Psi sells is very high and, thus, desirable; this is Psi's main strength in negotiating changes which are not legally mandated.
- The prospect of continuous cooperation is much more lucrative for the third parties than giving up a small portion of control over their promotional activities.
- Unsolicited promotional activity driven to excesses runs against the best interests of all three sides involved, resulting in dissatisfaction and diminished returns.
- The prospect of forcing Psi to adhere to the original contract taints the business relationship and also lowers the number of new users it recruits, which ultimately limits the data pool and the promotional activities which third parties can undertake.
- A strained business relationship creates negative word-of-mouth in the B2B sector and it also makes it less likely for Psi's business partners that Psi is willing to renew the contract upon its expiry.
- If pressed, Psi might feel compelled to retaliate by looking for irregularities in the business practices of its contractual partners, opening the door to a prolonged and bitter legal conflict. In the worst case, Psi may even default on the contract and simply accept the risk of having to pay damages to its business partners if they decide to sue for non-performance.

Paula reviews the six points and becomes quite certain the first two will be sufficient to convince the other side that Psi is requesting a reasonable change. She decides to

propose a stipulation that no Psi customer shall receive information about the same product or service more than twice and that the two times should be a minimum of four weeks apart. Paula and Lars then schedule a meeting with their contractual partners and proceed with the negotiation in order to implement a well-planned, positive change.

To recapitulate, on the B2C front, Psi CEO Paula has now hatched a plan to improve the company's terms of service and privacy policy which entails making both formatting and content revisions. Some of these revisions can be done by Psi's web developers, while others have to come from the company's legal counsel. Paula has integrated scientific research as well as business ethics and customer relationship management logics into her decision-making process, and she is ready to discuss her plan with Psi's relevant personnel and work out a plan of action together with them.

On the B2B side, Psi CEO Paula has reviewed the stipulations of the contracts, the legal background, and the business practices of her field of operations. She believes that she has a good chance of pushing through relatively small but meaningful changes to her existing third-party data brokerage agreements, and she also intends to fight for this if her business partners are not willing to cooperate. In tackling these challenges, the CEO has consciously relied on the CM process steps and used them to her advantage, both in zeroing in on the problems and in developing appropriate solutions.

Task 5: Present the Plan for the Improvements to the Disclosure Terms to Company Stakeholders and Map out the Updated Internal and External Communication Flows. Psi's CEO Paula is eager to take action on the urgent crisis. Each passing day exacerbates her company's PR and customer drain problems. After clarifying her revision plans, she calls a meeting with Psi's lawyer Lars, communications manager Charlie, copywriter Wesley, and web developer Don in order to discuss the changes and their implementation. She gives the presentation she has prepared based on her research and reasoning outlined in the previous tasks, and she opens the floor up for discussion on each proposed measure as well as for general observations on the latest critical developments.

Psi's lawyer Lars speaks first. He agrees with Paula's normative observations that standard disclosure texts are difficult to comprehend, sometimes even for legal professionals themselves, and that the European legislative concept of an 'average consumer' demands far too much of the general population whose rights it was designed to protect and serve. The experienced lawyer is also open to removing some of the obfuscating language in the privacy policy, provided that his communication and copywriting colleagues also approve of the change in tone and style this would bring about. Nevertheless, Lars is generally cautious about rewording the disclosure texts, especially with the intention of shortening and simplifying them, since it is a gargantuan task with what he considers to be dubious results. Most of all, Lars fears that any significant deviations from the more or less standardized wording, which originates in both European and national legislation, will provoke a flurry of **cease-and-desist notices** from competitors and consumer protection agencies who are always eager to level accusations of noncompliance with information obligations.

Contract Knowledge: Cease-and-Desist Letter

A cease-and-desist letter is usually a notice sent from one natural or legal person to another, urging them to stop an activity the former has deemed illegal (**cease**) and obliging the latter never to re-engage in that activity (**desist**). It is common to deluge competitors with cease-and-desist letters even for minor instances of noncompliance. Consumer protection authorities are also notoriously particular about the phrasing and formatting of consumer-facing information. Dealing with a cease-and-desist letter can be costly for a business. To comply with it, companies need to revise internal processes and may face permanent limitations on certain business practices; fighting them in court takes time and can cost several thousands to tens of thousands of Euros, depending on the court's decision and the severity of the disputed noncompliance. For these reasons, business lawyers are very aware of the risks of noncompliance and aim to follow the letter of the law closely, even if this means that the information they provide to consumers may be difficult to understand or assimilate.

For **further reading** on cease-and-desist letters and their widespread applications, see [8].

After Lars' statement, Paula is less convinced of her plan for a sweeping revamp of Psi's terms and policies. She turns her attention to Charlie and Wesley to consult their media expertise. Charlie speaks first and confirms that it would be both feasible and even desirable to revamp Psi's data handling processes. This would provide customers who read such texts thoroughly with clearer information and allow them to make a conscious decision to accept or reject the terms of the privacy policy, while those who do not would not be bothered by the fact that Psi trades in their personal data. However, Charlie is of the opinion that rephrasing the texts is not the optimal course of action in this case. In fact, she would rather preserve the contract and its ancillary information as they are. In her view, all efforts should rather be directed towards mounting an information campaign that presents Psi in a prominent, palatable, but not legally binding form, i.e. developing a comprehensive FAQ section. Both Lars and Paula are intrigued by this proposition. They consider it an elegant solution to the crisis since it demonstrates that Psi takes customer feedback and satisfaction seriously, while at the same time leaving the legal framework of the contract intact and minimizing the need for redrafting and implementation efforts.

Wesley is also taken with the idea because he is much more comfortable drafting FAQs than painstakingly revising legal documents alongside Lars. He already has compiled a general informative question-and-answer page and feels confident that he can synthesize the main points of the terms of service and the privacy policy into accessible chunks of information that sound positive. He also feels that customers are more likely to comprehend, respect, and ultimately accept them in this form. Wesley will transform Paula's insights into a clear and transparent information design and cooperate with web developer Don to present the FAQs in line with the best practices identified in the literature, including clear language, presentation of the information in the form of graphs,

images and tables, and a clearly identifiable text structure. Don supports the idea, too, citing website statistics which show that users have almost zero interest in the terms and conditions or the privacy policy pages. This stands in contrast to the relatively high popularity of the general FAQ page where users spend between 17 and 375 s (see Sect. 2.3.2 for additional, externally oriented communication measures.)

As the discussion unfolds, Paula notes to herself that the changes to be made to the contract itself will be minimal, but that, in the B2C context she is presently addressing, the paraphernalia (e.g. the FAQ sections and privacy policy) are closely linked to the contract proper; they become inseparable from it when it comes to defining customer experience and satisfaction. Managing the paraphernalia will thus become a contract management task in its own right, which demonstrates how in certain business settings 'the contract' is a composite of several client-facing documents, each with its own far-reaching pre- and post-award consequences.

2.3 Implementation of the Decision

After conducting her extensive analysis of the current state of Psi's contractual documentation and consulting the latest research findings on improving the transparency of online contracts, Paula has to communicate to her team her decision to significantly modify and improve the status quo as well as her wish to request a B2B contract change. As founder and CEO, she has taken the initiative and prepared a comprehensive presentation to convince her colleagues that her decisions must be implemented. However, Paula also wants to exploit the expertise of her great legal, communications, and development personnel in a fruitful exchange and remains open to alternative suggestions with greater success potential than her own.

2.3.1 Internal Implementation

Since Psi UG is an SME, the internal communication and implementation of the decision as described above are not—and need not be—institutionalized.

2.3.2 External Implementation

Directly communicating Psi's desire to improve and the concrete measures it has taken to increase the transparency of its contract terms to its customers is a crucial step in solving the consumer backlash crisis the company is facing. This communication needs to take place across multiple channels and in various forms to maximize its efficacy. The Psi team has a number of ideas as to how to achieve quick and solid gains in that department. For a start, web developer Don suggests utilizing Paula's recommendations on meaningful hyperlinking to **nudge** Psi customers to read the new FAQ webpage and to draw connections between items on it.

Explanation: Nudge Theory

A **nudge**, brought to prominence by economic theorists Richard Thaler and Cass Sunstein, is an element built into a decision-making process that affects human behavior in predictable ways without limiting overall freedom of choice. The classic example is placing a housefly decal sticker on an airport urinal to improve aiming and reduce splashing. Nudge theory postulates that such soft forms of coercion, somewhat euphemistically termed **choice architecture**, offer a better way of guiding consumers to make good choices than outright obligations or bans. Since it entered the mainstream in the late 2000s, nudge theory has found broad application in state policy as well as private business practice. Ethicists, among others, have challenged the benevolent premise of nudging and likened it to psychological manipulation or social engineering. While some consider nudging a subversive affront to fundamental human liberties, many others accept and use it as an efficient way to exert social influence in the name of the greater good.

For a **general introduction** to **nudge theory**, see [20].

According to Don, Psi should nudge every new customer to visit the privacy FAQ section by highlighting it in the website's main navigation menu. Don would also like to integrate mouse-over buttons in the registration window explaining why Psi is asking for this or that item of personal data. Similar mouse-over information will be integrated into the process of completing a contract, where the privacy policy is broken down into palatable chunks and presented at the relevant stages of completing the contract. Each such mouse-over item ends with a "read more…" link to the relevant item in the FAQ section. Don believes that the clarity and minimal user action required behind this solution will work as an effective nudge for customers to get informed. Wesley and Lars like the idea and agree to work closely with Don on the wording and implementation of the mouse-over solution.

Apart from nudging, Psi's good will and dedication to transparency need to be directly communicated in some way. Charlie, therefore, proposes to contact all old Psi users, including the ones who have recently terminated their memberships in anger, with a special announcement that clarifies the company's privacy policy and terms of service, points to the new FAQ section, and offers a symbolic olive branch. Paula questions the legality of including recent terminations in the contact pool, but Lars assures her the privacy policy stipulates that Psi may keep records on customers for up to 24 months after they have left the platform, and that direct marketing is one of the stated purposes behind this stipulation. Paula then asks Charlie and Wesley to draft a special version of the newsletter for those customers, acknowledging their extreme levels of frustration and with the explicit aim of making amends and winning them back. The two agree that this special treatment is indeed appropriate.

Paula also requests that every newly registered user receives an automatic email containing important details from Psi's privacy policy and a direct link to the privacy FAQ webpage. This measure is designed to preempt unpleasant surprises and expressly show her redoubled commitment to transparency. Her colleagues agree with her on that point, too.

Paula and her associates thus map out a comprehensive external communication strategy comprising a website overhaul and targeted newsletter campaigns aimed at informing new users, retaining current ones, and reaching out to disgruntled former customers with an explanation and an invitation to rejoin. Internally, the group decides to meet regularly every fortnight for the sole purpose of monitoring the implementation of the new measures and monitoring the latest developments. Charlie and Wesley are tasked with developing strategies and texts which must then be approved by Lars. Then Don takes over the technical implementation, which is once again to be okayed by Lars and finally presented to Paula before it goes live. Once the situation is under control, Paula intends to take herself out of the loop and allow the rest of the group to make minor adjustments without the need for her final approval.

Right after the meeting, the team gets down to work and implements the agreed changes: (a) Charlie, Lars, and Wesley revise the obfuscating language in the privacy policy; (b) Wesley and Don develop a blueprint for the nudging website strategy, which Charlie and Lars okay and extend until the privacy FAQ webpage goes live and transaction-specific contract information accompanies the contract conclusion process in bite-sized chunks; (c) Charlie and Wesley draft the three newsletter versions for the different user groups and send them out.

On the B2B side, CEO Paula and lawyer Lars proceed with the negotiation plan they have hatched. They decide to negotiate with each of Psi's data trading partners individually in order to maximize their negotiation strength and to be able to maneuver according to each specific case. They create a numbered list of their B2B contract partners, starting with the most valuable and lucrative ones and going downwards from there. Unsurprisingly, the majority of companies on the list are very receptive to the changes Paula proposes, and her arguments as laid out above strike them as reasonable and mutually beneficial in the long run. Lars drafts the changed B2B contract in accordance with the results of the negotiation, and the two sides then implement it.

2.3.3 Evaluation of the Decision

Task 6: Evaluate the Efficacy of the Measures.
Now is the time to evaluate the effects of each measure. To do so, CEO Paula should focus on the CM process steps **monitor** and **evaluate**. The challenges in this case study touch equally upon knowledge management and risk management. Paula was clearly unaware of the risk which the original opaque terms and policies posed for the very existence of Psi. Yet, she was quick to use knowledge and information management to her advantage by doing research on information transparency and implementing legal, content, and presentation revisions. Now she can also manage the risk better through more careful and thorough observation of key customer and business analytics.

To gauge the customers' response to the measures, the Psi team will rely on the following standard practices and measures.

- Website analytics (e.g. Google Analytics or similar) will determine whether the revised privacy policy is garnering more user attention, both in terms of visit count and visit

duration. The path users take to view the actual policy will also illustrate whether the nudging strategy works as planned, i.e. how often customers click on "read more…" in the various mouse-overs. Web analytics will also characterize the success of the privacy FAQ webpage where a dramatic uptick in longer visits is to be expected.

- The effectiveness of the newsletter campaign can also be tracked with dedicated applications, which follow each campaign's 'open,' 'read,' and 'engage' rates and also recipients' reactions to, and interactions with, the message and the hyperlinked content therein. Again, a significant increase in user attention to the privacy FAQ webpage and a lesser but palpable rise in the number of visits to the complete privacy policy are expected here.
- Ultimately, the best measure of success here will be the Customer Retention and Customer Acquisition rates for the current period. A reversal of the negative trend in retaining old customers and an upward trend in acquiring new ones would be the best indicators of success. To gain additional insights, Paula and Don can also dive deeper into the Repeat Purchase Rate, which is a measure of customer loyalty.
- In addition, Paula and Don would be wise to monitor the Customer Lifetime Value, or how much revenue the average Psi customer brings, and compare that to the costs of acquiring and retaining customers. However, this is a more medium- to long-term measurement which will yield meaningful results only after the customer backlash has ended and Psi has returned to regular operational mode.
- Charlie also suggests that a customer satisfaction survey be sent to customers on the third day after their transaction is completed. It will feature a single question: "How likely is it that you recommend Psi to others?" on a scale from 1 (not at all likely) to 10 (definitely will) and a free-text comment box for specific observations. This will enable Psi to determine how many of its customers are truly engaged with Psi's services and trust it enough to promote them. Customers with scores of 0–6 are usually counted as brand detractors, those with 7–8 as passives, and those with 9–10 as promoters.
- Finally, Paula also makes it a point to monitor her B2B acquisition rates in order to ensure that the greater control Psi retains over the data brokerage contract does not turn potential partners away. This will allow her to balance keeping her company's reputation and maintaining a crucial revenue stream.

Setting appropriate benchmarks for each of the measures above is a trickier task. On the one hand, it depends on Psi's previous track record in each category; on the other, the degree of success or failure of each measure is for CEO Paula to determine based on the company's liquidity, revenues, funding, actual growth, and growth prospects, among other indicators. Paula and her team are determined to pull the company out of the PR slump, and they will monitor all relevant measures closely in order to be able to course-correct efficiently if they run into trouble and to anticipate major hurdles before they become apparent.

2.4 Process Optimization

As a result of Paula's insights into the importance of contract paraphernalia for the contract-proper's correct functioning, a new avenue for process optimization has emerged, namely the need to 'translate' the defining features and stipulations of the contract from legally sound but inaccessible language into a consumer-friendly form. The transition from a dense 'legalese' text to peppy FAQ is not new to the Psi team, but it clearly needs to be expanded. For this purpose, communications director Charlie, copywriter Wesley, and lawyer Lars will have to get together not only now in the face of the crisis, but also in the event of any future need for updates to the terms and conditions or the privacy policy, in order to devise customer-friendly versions of the new contractual situation. The trio then will have to involve web developer Don in the technical application of the changes. This translation of content proves to be indispensable to effective contractual management in B2C situations where the contract can only perform its function correctly if it is read, understood, and acknowledged by the customer in all its relevant stipulations.

In the B2B context, the optimization required here pertains to all future data brokerage agreements which must better safeguard Psi's interest and the perceived privacy of its users. Paula and Lars will therefore draft a more elaborate data usage section for the B2B contract in order to better manage the transaction and achieve better results for all parties involved.

More generally, Psi has come out of this challenge with a greatly enhanced risk management toolbox and experience. After overcoming this particular crisis, CEO Paula has taken a hard look at her failure to anticipate and prevent the customer backlash, resulting in a shift in both her B2C and B2B philosophies. In the former realm, she has made transparency a cornerstone of every CM step; in the latter, she has introduced safeguards which favor control and authority over quick earnings. In addition, all key figures in the startup have gained a much deeper understanding of the business value of transparent information. The newly found knowledge can be implemented in similar crises in the future where the PR and customer outreach measures can be re-applied for damage control. The effective use of analytics and business statistics will serve as an early-warning system, and Paula will tackle future problems with greater confidence and with the same high level of preparedness as now.

2.5 Actual Execution

Psi simplified its privacy policy and carried out a major overhaul of its website to include explicit references to its most crucial and potentially controversial stipulations before and during the conclusion of the consumer contract. They monitored customer behavior on the website, and the click paths and durations of visits to webpages suggest that users spend more time on the newly introduced privacy FAQ webpage. Twelve per cent of new

users jump from the mouse-overs to the FAQs in the midst of concluding a contract to find out more about how Psi intends to handle their personal data, and only a negligible number of users abandon their shopping carts once they have gained this information. The customer exodus has been stopped, the company's reputation is on a slow but consistent upward climb, and the customer retention measures are all positively trending.

One recurring comment in the customer feedback, however, is the amount of third-party spam which engulfs consumers. Even though they are not surprised by it anymore, they still report it as a problem that they have with the service, and one that is serious enough to prevent them from recommending it. Since Psi stands to benefit greatly from positive word-of-mouth campaigning, CEO Paula finds herself in a new conundrum, this time on the B2B side of Psi's contractual management needs.

To address this problem, Paula and Lars speak to their counterparts via videoconference and explain the situation in detail, emphasizing the mutual benefits of reining in third-party promotion and cooperating on the relatively small change required. As expected, the quality of Psi's data and the open dialogue initiated by the CEO suffice for a convincing argument. The third-party data purchasers agree on the limitation originally devised by Paula and the legal representatives of the companies hash out the change in language. Lars also includes the final stipulations in the data brokerage contract template that Psi will use in all such future transactions in order to avoid a repeat of the dire situation here. As the company returns to growth and higher user satisfaction, more third parties become interested in data brokerage agreements with Psi and have no problem accepting the updated contract. Problems arise rarely, and Lars and Paula are able to address them swiftly thanks to the instructive experience they have been through and the careful planning they put into the new B2B contract.

2.6 Learning Outcome

2.6.1 CM Value for the Case Study

This fictional case study demonstrates the wide range and flexibility of the CM Model when it comes to structuring and guiding contractual relations. It expands the traditional view of the B2C contract by putting the concept of transparency in the spotlight and illustrating what a vital role it plays in consumer-facing settings. Applying the CM process steps 'draft,' 'implement,' 'monitor,' and 'evaluate' not only to the B2C contract itself but also to contractual paraphernalia such as the company's privacy policy and its non-legally binding but crucial simplified presentation in the form of an FAQ page, has rendered the company leadership's decision-making process clearer and more effective. Enhancing the drafting and implementation steps, with a special focus on their transparency, broadens the already innovative and positive view of the contract as a management tool between legal entities and demonstrates that CM can also play a vital role in maintaining healthy relationships between businesses and natural persons, i.e. their

customers. Monitoring and evaluating the enacted changes closes the CM loop and guarantees that problems do not go unnoticed any longer than necessary and solutions are constantly tested and, if necessary, tweaked to deliver even better results.

To turn to the B2B modification part of the case study, all Contractual Management steps come into play as an existing contract undergoes changes, which also will affect all future contracts. This is a classic CM scenario in which the legal, business, and social ramifications of changing a contract in the face of shifting circumstances are meticulously mapped out in order for the optimal decision to crystallize. The model's ability to streamline systematic problem-solving and take all relevant perspectives into account shines through and produces a strong, legally and socially sound negotiating position which ultimately brings about positive change for the company. The monitoring and evaluation built into the CM Model once again provide confirmation that the course of action was correct, and the model thus provides continuous support for good decision-making on both B2B and B2C transactions.

The case study also demonstrates how the different steps relate to distinct fields of management. Most importantly, it shows how central transparency is to knowledge management: even the clearest, most ironclad terms of a contract will fail to produce understanding and appropriate action when a party is not sufficiently able to comprehend them. Thus, in the B2C context, partial simplification and considerable elucidation of the contract allow it to fulfill its management functions. Each process step—from 'plan' to 'evaluate'—supports this overarching effort as followed in this chapter. Ensuring that customers fully understand the company's practices also makes an important contribution to risk management as the broad-based consumer backlash and tainted company reputation threatened the business's very existence at the height of the crisis. Transparency thus proves to be essential to effective contractual management in this case.

In turn, the B2B modification of the case study illustrates the importance of information and change management. Internet-based companies possess troves of valuable sensitive data, and they have to be very careful in how they handle and trade it. This becomes a central consideration at every CM process step, and it leads the company through a successful renegotiation of old agreements and sets up all future ones on firmer ground. The latter is an additional risk management measure which helps the company in our example stay out of future trouble. By introducing clearer communication flows and continuously monitoring the effects of its changes, the business improves its information management practices and improves both its internal and external communication flows.

2.6.2 Case Study Value for the Reader

The reader learns about the central role of information transparency in B2C contracts. As a concept of growing importance in both legislation and business practice, information transparency is shown to be a key commercial asset which can make or break a business venture, especially a new and small one. The reader understands how to identify

transparency deficiencies and how to address them in a manner that is legally sound and also efficient from the management standpoint. The case study is particularly useful for illustrating the difference between fulfilling legal requirements and achieving meaningful information transfer—a crucial distinction which is only hinted at in legislation and can best be understood in practical terms. To avoid a potentially costly trial-and-error sequence, this chapter provides a realistic example of maintaining high legal and high information standards at one and the same time, which serves the reader well on his/her quest for optimal contract management.

In the course of the case study, the reader is also introduced to important business, economic, and legal concepts, such as data valuation, information obligations, cease-and-desist letters, and nudge theory. He or she understands the origins and logic of each of these constructs or legal instruments, and also learns how to use them to his or her advantage in this and other business contexts. In the B2B dimension of the case study, the reader is also confronted with a change management task which gives him/her a taste of negotiations from the seemingly weak position where the contract has not been drafted on their side. To strengthen his or her case, the reader learns to look at business logic and socio-cultural norms which can bolster his or her negotiating stance. Here the management potential of the contract is affirmed and further embedded into real-life business practices, teaching the reader to rely on the written agreement but also to cast an eye beyond it. This is an essential skill in change management, on both sides of the change request. To support the reader's decision-making processes, the chapter also includes relevant passages from seminal EU legislation on the subject of consumer rights in distance contracting and protection of personal data.

The case study therefore provides an example of the contract as a management tool, taken as a sum of its classical and contextual parts, i.e. the written and signed agreement, its amendments, summaries, and client-facing presentations as well as the norms and practices which frame its corporate execution. Under the leitmotifs of transparency and knowledge management, readers learn to steer B2C and B2B business relationships with effective information presentation and management at their core. They also learn to use the contract as a basis for clarification, negotiation, and change, and come out better prepared to tackle real-world business problems arising from a lack of transparency, unclear agency, and poor corporate planning decisions.

Appendices

Appendix 1: Extract from Directive 2011/83/EU

Enacted by the European Parliament and of the Council of 25 October 2011 on the subject of consumer rights [25].

"[…]

[Recital] (34) The trader should give the consumer clear and comprehensible information before the consumer is bound by a distance or off-premises contract, a contract other than a distance or an off-premises contract, or any corresponding offer. In providing that information, the trader should take into account the specific needs of consumers who are particularly vulnerable because of their mental, physical or psychological infirmity, age or credulity in a way which the trader could reasonably be expected to foresee. However, taking into account such specific needs should not lead to different levels of consumer protection.

[Recital] (35) The information provided by the trader to the consumer should be mandatory and should not be altered. Nevertheless, the contracting parties should be able to expressly agree to change the content of the contract subsequently concluded […]."

Appendix 2: Extract from Directive 2002/58/EU

Enacted by the European Parliament and of the Council of 12 July 2002 on the subject of processing of personal data and the protection of privacy in the electronic communications sector [24].

"[…]

[Recital] (6) The Internet is overturning traditional market structures by providing a common, global infrastructure for the delivery of a wide range of electronic communication services. Publicly available electronic communication services over the Internet open new possibilities for users but also new risks for their personal data and privacy.

…

[Recital] (9) The Member States, providers and users concerned, together with the competent Community bodies, should cooperate in introducing and developing the relevant technologies where this is necessary to apply the guarantees provided for by this Directive and taking particular account of the objectives of minimizing the processing of personal data and of using anonymous or pseudoanonymous data where possible.

[…]

[Recital] (30) Systems for the provision of electronic communications networks and services should be designed to limit the amount of personal data necessary to a strict minimum. Any activities related to the provision of the electronic communications service that go beyond the transmission of a communication and the billing thereof should be based on aggregated, traffic data that cannot be related to subscribers or users. Where such activities cannot be based on aggregated data, they should be considered as value added services for which the consent of the subscriber is required.

[Recital] (31) Whether the consent to be obtained for the processing of personal data with a view to providing a particular value added service should be that of the user or

of the subscriber, will depend on the data to be processed and on the type of service to be provided and on whether it is technically, procedurally and contractually possible to distinguish the individual using an electronic communications service from the legal or natural person having subscribed to it.

[Recital] (32) Where the provider of an electronic communications service or of a value added service subcontracts the processing of personal data necessary for the provision of these services to another entity, such subcontracting and subsequent data processing should be in full compliance with the requirements regarding controllers and processors of personal data as set out in Directive 95/46/EC […].

Article 13
Unsolicited Communications

1. The use of automated calling systems without human intervention (automatic calling machines), facsimile machines (fax) or electronic mail for the purposes of direct marketing may only be allowed in respect of subscribers who have given their prior consent.
2. Notwithstanding paragraph 1, where a natural or legal person obtains from its customers their electronic contact details for electronic mail, in the context of the sale of a product or a service, in accordance with Directive 95/46/EC, the same natural or legal person may use these electronic contact details for direct marketing of its own similar products or services provided that customers clearly and distinctly are given the opportunity to object, free of charge and in an easy manner, to such use of electronic contact details when they are collected and on the occasion of each message in case the customer has not initially refused such use.
3. Member States shall take appropriate measures to ensure that, free of charge, unsolicited communications for purposes of direct marketing, in cases other than those referred to in paragraphs 1 and 2, are not allowed either without the consent of the subscribers concerned or in respect of subscribers who do not wish to receive these communications, the choice between these options to be determined by national legislation.
4. In any event, the practice of sending electronic mail for purposes of direct marketing disguising or concealing the identity of the sender on whose behalf the communication is made, or without a valid address to which the recipient may send a request that such communications cease, shall be prohibited.
5. Paragraphs 1 and 3 shall apply to subscribers who are natural persons. Member States shall also ensure, in the framework of Community law and applicable national legislation, that the legitimate interests of subscribers other than natural persons with regard to unsolicited communications are sufficiently protected."

Appendix 3: Extract from Directive 95/46/EC

Enacted by the European Parliament and of the Council of 24 October 1995 on the subject of protection of individuals with regard to the processing of personal data and on the free movement of such data [26].

"[…]

For the purposes of this Directive:

(a) 'personal data' shall mean any information relating to an identified or identifiable natural person ('data subject'); an identifiable person is one who can be identified, directly or indirectly, in particular by reference to an identification number or to one or more factors specific to his physical, physiological, mental, economic, cultural or social identity;
(b) 'processing of personal data' ('processing') shall mean any operation or set of operations which is performed upon personal data, whether or not by automatic means, such as collection, recording, organization, storage, adaptation or alteration, retrieval, consultation, use, disclosure by transmission, dissemination or otherwise making available, alignment or combination, blocking, erasure or destruction;
(c) 'personal data filing system' ('filing system') shall mean any structured set of personal data which are accessible according to specific criteria, whether centralized, decentralized or dispersed on a functional or geographical basis;
(d) 'controller' shall mean the natural or legal person, public authority, agency or any other body which alone or jointly with others determines the purposes and means of the processing of personal data; where the purposes and means of processing are determined by national or Community laws or regulations, the controller or the specific criteria for his nomination may be designated by national or Community law;
(e) 'processor' shall mean a natural or legal person, public authority, agency or any other body which processes personal data on behalf of the controller;
(f) 'third party' shall mean any natural or legal person, public authority, agency or any other body other than the data subject, the controller, the processor and the persons who, under the direct authority of the controller or the processor, are authorized to process the data;
(g) 'recipient' shall mean a natural or legal person, public authority, agency or any other body to whom data are disclosed, whether a third party or not; however, authorities which may receive data in the framework of a particular inquiry shall not be regarded as recipients;
(h) 'the data subject's consent' shall mean any freely given specific and informed indication of his wishes by which the data subject signifies his agreement to personal data relating to him being processed.

[…]

SECTION II
CRITERIA FOR MAKING DATA PROCESSING LEGITIMATE
Article 7

Member States shall provide that personal data may be processed only if:

(a) the data subject has unambiguously given his consent; or
(b) processing is necessary for the performance of a contract to which the data subject is party or in order to take steps at the request of the data subject prior to entering into a contract; or […]
(f) processing is necessary for the purposes of the legitimate interests pursued by the controller or by the third party or parties to whom the data are disclosed, except where such interests are overridden by the interests for fundamental rights and freedoms of the data subject which require protection under Article 1 (1).

SECTION III
SPECIAL CATEGORIES OF PROCESSING
Article 8
The processing of special categories of data

1. Member States shall prohibit the processing of personal data revealing racial or ethnic origin, political opinions, religious or philosophical beliefs, trade-union membership, and the processing of data concerning health or sex life.
2. Paragraph 1 shall not apply where:
   (a) the data subject has given his explicit consent to the processing of those data, except where the laws of the Member State provide that the prohibition referred to in paragraph 1 may not be lifted by the data subject's giving his consent; […]

SECTION IV
INFORMATION TO BE GIVEN TO THE DATA SUBJECT
Article 10
Information in cases of collection of data from the data subject

Member States shall provide that the controller or his representative must provide a data subject from whom data relating to himself are collected with at least the following information, except where he already has it:

(a) the identity of the controller and of his representative, if any;
(b) the purposes of the processing for which the data are intended;
(c) any further information such as
   – the recipients or categories of recipients of the data,
   – whether replies to the questions are obligatory or voluntary, as well as the possible consequences of failure to reply,

– the existence of the right of access to and the right to rectify the data concerning him

in so far as such further information is necessary, having regard to the specific circumstances in which the data are collected, to guarantee fair processing in respect of the data subject."

Appendix 4: Excerpts from Psi UG's Terms of Service (Until November 2017)

"[…]

(9) Our service stays high-quality and competitive also thanks to your willingness to provide us with personal information about yourself. This personal information might be both one-time and recurring in nature, the former referring to the data you supply to us upon registering your account and the latter pertaining to our daily mood and sleep check-in data we strongly urge you to share with us. We may use this data in a variety of ways which can improve our service to you and can also serve our company's own interests.

(10) We operate on the basis of mutual trust and value your cooperation highly. However, should you choose not to provide some of the personal data we ask for, we will still do our best to provide you with top-notch service. Nevertheless, keep in mind that non-compliance may result in suboptimal results and limits our liability in cases you are not content with the service we have rendered.

(11) By agreeing to these terms, you also certify that you will keep your personal information on our site up to date and accurate.

(12) All matters of privacy and personal data are further explained in our Privacy Policy which you should read and accept before using our services.

[…]

(15) We reserve the right to update and amend the terms of service as we see fit. We will contact you periodically to turn your attention to possible changes and updates which affect you as a customer. "

Appendix 5: Excerpts from Psi UG's Privacy Policy (Until November 2017)

"[…]

(11) You agree that Psi may collect and store your personal information, including but not limited to your name, physical and email address, profile info, transaction history, and daily check-ins. We may use this information for our internal purposes as well as

occasionally pass it on to third parties who might then use the information we provide to them for the purposes of occasional promotional communications.

(12) You allow Psi to exercise its own discretion in selecting the third parties, to whom we may make available some of your personal data. We reserve the right to periodically review and update our agreements with third parties, which can have an influence on the amount and kind of personal information we might share with them.

[…]

(17) Should you have any objections to the amount or kind of personal information we might be sharing with third parties, you may get in touch with us and supply a formal inquiry as to the exact nature of our activities. We take such requests very seriously, our team reviews them regularly, and we will get back to you with a personal response in due time. Until you hear back from us, we urge you to refrain from any further actions even though your principal rights and freedoms as customer remain unrestrained under this policy."

Appendix 6: Customer Personal Data Collected by Psi

(a) Upon registration (one-time)
- Name
- Physical/postal address
- Email address
- Nationality
- Age
- Gender
- Relationship status
- Pets
- Income bracket
- History of medical and/or psychological problems or ailments
- History of life and/or career coaching (when? how long? how successful?)

(b) Upon sign-in (recurring)
- How happy are you feeling today? (scale of 1–10)
- How many hours of sleep did you get last night?
- Sum up your feelings in the days since your last sign-in in 1–3 words!

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The Second-Hand Software Case—Knowledge Management in the Contract Planning Stage

3

Bert Eichhorn

Contents

B. Eichhorn (✉)
SRH Hochschule Berlin, Berlin, Germany
e-mail: bert.eichhorn@srh.de

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Abstract

This case study deals with the purchase of new software on the one side and the reselling of the used software and knowledge management on the other side, the latter being necessary for successfully managing the preparation of such negotiations. It highlights the different sources of information which must be approached for successfully negotiating a deal (information input), as well as the need for the dissemination of knowledge and experiences to other company functions which depend on such data for current processes as well as for future activities (information output). Furthermore, the case study demonstrates the importance of risk management for the preparation of a transaction, and the fact that such risk management forms a part of the knowledge management system. It applies the Contractual Management Model (CM Model) from the viewpoint of a company manager and thereby demonstrates the necessary interaction between different management fields (here, especially risk and knowledge management) during the CM process steps plan and draft. The target-orientation of the CM Model stresses the importance of contract design for the subsequent contract handling activities of a company. This way, it becomes apparent that the possibility to resell the used software depends on the content of the purchase contract for the new software through which the seller can try to restrict such resale. The sales contract thus becomes a steering instrument for business.

Keywords	Resale of software license, exhaustion principle, limits of freedom of contract, European versus national law, negotiation checklist, lessons learned database with checklists
Principle management topic	Information and communication
Institution	Small and medium sized enterprise (SME), private, profit
Subject of management	Relationship (transaction)
CM process step	Plan, draft
Management field	Knowledge management, risk management
Contract type	License agreement, purchase contract

Editor's Note: For a full understanding of the CM Model's practical benefit for the case study, the reader may have to peruse at least sect. 1.4.4 and 1.4.5 of Part I. The keywords used above to characterize the area of contract application are explained in the key system preceding the case studies in Part II.

3.1 Challenge

3.1.1 Set of Facts

Company B (reseller) is a media & communication company based in Cologne, Germany, with a turn-over of roughly EUR 50 million and about 200 employees. It has a long-standing business relationship with Company A from the Netherlands, which develops software solutions (developer). In 2013, Company B considers buying a standard administration software from Company A for use on several computer workstations in its translation department at a price of approximately EUR 50,000 (**first case**).

Company A offers licensing agreements based on its standard terms and conditions. The software itself can be installed unlocked, i.e. no validation key is necessary to activate the software on a computer. Company A intentionally chooses a business model based on a licensing agreement and not a sales agreement in order to reduce the risk of resale on the second-hand market. Company B has to download the software from the webpage of Company A and, therefore, will not receive the software on a physical data medium, such as a CD or an alternative physical storage device which was the common means of distributing software in former times. The licenses for Company B shall be unlimited in time. Due to the pricing schemes offered on the market, it is common that time-limited licenses are not issued.

Company B requires the software only for a few years because it eventually intends to outsource its translation department. It therefore considers the option to resell the used standard administration software later on to another company (potential buyer). A market analysis undertaken by Company B revealed that the software could be resold on the market in two years' time for about EUR 25,000. Company B also deliberates not buying the software from Company A in case it is economically or legally too risky to resell the software, and instead outsourcing the activities of the translation department right now.

Since the resale of used software is a new topic for Company B and the executive board expects it to be of some importance in the future, the purchase of the standard administrative software has been made a project covering the purchase of the software from Company A as well as the management of lessons learned. Company B has no contract management system in use, and lessons learned data are managed through various disjoint databases. Members of the project team include Company B's CIO, the head of the translation department, and X, an experienced employee in the procurement department who has been assigned the project coordination.

X is aware of the legal intricacies related to the resale of used software and knows there have been different verdicts by various German courts on the subject matter. He has attempted to get an overview of the legal situation on various online portals and by discussing the issue with procurement colleagues from other enterprises. Because he couldn't retrieve a clear picture from it, and since Company B as a medium-sized enterprise does not have its own legal department, he has consulted with the national procurement

association and with Company B's employer's association. Both have stressed the ambiguity of the legal situation and the risks associated with such a deal but emphasized that in the end it was Company B's decision whether or not to run such a risk. Finally, X resolved to consult a lawyer. After inquiring about the costs, which proved to be manageable for Company B, and obtaining the approval of Y, the head of the procurement department, X hired Lawyer Z who has frequently worked for Company B and is experienced in German and European business law and, in particular, in Intellectual Property (IP) matters.

Project Coordinator X knows that the contract template Company A uses contains the following clause which it is not willing to delete or modify: "Acquirer may not assign the rights under this agreement without Company A's prior written consent." Furthermore, Y knows it's a possibility that Company A might introduce other clauses during the negotiation which could limit the resale of the software to a potential buyer on the second-hand-market.

In the weekly work session of the procurement department, Y inquires about the progress of the standard administration software project. X explains that he has met with Lawyer Z and received all relevant legal information. Y announces that he will conduct the negotiations with Company A and that for this purpose he needs a negotiation checklist referring to the legal issues by next Wednesday as well as substantiated information on how X intends to organize the lessons learned processes. He also suggests a checklist to be filed for any future software purchases that may be followed by a resale of the used software.

Modification of the set of facts (second case) In this scenario, which mostly corresponds to the first case, the purchase of the standard administration software and the reselling of the used software occur in the year 2007. The potential buyer will receive a physical storage medium from Company B, which contains copies of the used software; this was the common means to transfer software at that time.

3.1.2 Operating Procedure

3.1.2.1 Author's Explanations

In summary, Project Coordinator X has to devise two checklists. The negotiation checklist with a special focus on the option of reselling the standard administration software to a potential buyer serves to minimize negotiation risks for Company B (risk management). The second (knowledge) checklist also focuses on the option of reselling the used software to a potential buyer and builds upon the negotiation checklist as well as on the information provided by different departments and functions of Company B (knowledge management). In the actual case, it is named 'Used Software Resale checklist' (USR-checklist) and shall help to structure future purchases of software with the option to resell it to a potential buyer.

The CM Model can be used to systematically approach the tasks Project Coordinator X has to deal with. Accordingly, this case study focuses on the plan and draft steps of

the Contractual Management cycle. These steps are a prerequisite for a successful negotiation preparation for the purchase of the standard administration software and its later resale on the second-hand market. Further delineation of the negotiation process itself and contract conclusion as part of the CM process step draft, however, is—as far as the negotiation checklist is concerned—not to be considered here. For further use of the negotiation checklist in subsequent negotiations by any of Company B's departments, it is necessary that the implementation, monitoring and evaluation steps are anticipated internally and externally with regard to the necessary information flows within Company B. This is manifested in particular through the lessons learned database.

To cope with these tasks, it is essential for Project Coordinator X to identify and to analyze the risks of a possible reselling of the software on the second-hand market (risk management) and to produce a reliable negotiation checklist with focus on these risks. The second checklist, the USR-checklist, serves to identify the inputs and outputs which need to be generated internally or externally by Company B (knowledge management) in order to secure a satisfactory negotiation outcome for similar transactions in future.

In the actual case, **knowledge management** requires particular consideration, because it connects the three other management fields of the CM Model (corporate management, risk management, and management of relationship) through processes of mutual exchange of information (input and output) in the negotiation process: The act of purchasing new software from a developer and the planning of reselling the used software to another company are linked in order to better prepare for the design and monitoring of the negotiations. The negotiations themselves and—even more so—the contract resulting from a successful negotiation, are of an "organic nature" (**Biology of the Contract**).

Contract Knowledge: Biology of the Contract

A contract is a living organism that is in a constant state of exchange with its surroundings. Such a 'homeostatic' character may have significant influence upon the interpretation of the contract's contents. Before and during negotiations (**contract antecedent**), the **business case**, which is often not expressed and instead implicitly addressed, f.e. in section 313 of the German Civil Code, influences the contract content.

Upon fulfillment, the contract continues to have effects, for instance as evidence or a matter of taxation or business auditing **(contract heritage)**. From an external perspective, its content is influenced by judicature and legislation **(outer life of contract)**; from an internal view it can develop itself from an internal origin **(contract inner life)**, f.e. though automatic prolongation clauses [2].

From a knowledge management perspective, the contract is in a permanent data exchange with the environment in which it is created. Such intense interactions before and during negotiations as well as after the completion of the contract require particularly complex coordination efforts within and sometimes even outside the company ([5], p. 17).

In the set of facts presented here, the focus lies on information procurement and learning processes initiated through the analysis of transaction risks which requires different competencies for the intended business. The emphasis is not on reporting the negotiation activities of individual employees and on their integration into the negotiation process, which is otherwise highly relevant for the conclusion of the contract; instead, the focus here is on the information needed by Company B, its data input and output processes, as well as the process optimization for future preparations of negotiations on sales and resales of used software based on a thorough risk analysis. With regard to knowledge management, this means in particular: generating negotiation knowledge for future software purchases **(knowledge creation)**, collecting and analyzing relevant contract information **(knowledge evaluation)**, and **sharing knowledge** with other departments along with the optimization of associated processes in the company.

In this context, knowledge management and risk management together with the checklists allow for a holistic view on the involved enterprises and their internal and external relations with each other. In this respect, the following questions arise:

Risk Management	Which risks (commercial, legal, ethical, operational, etc.) are relevant for Company B in the purchase of software from Company A and the resale later as second-hand software to a potential buyer and, therefore, have to be incorporated into the risk checklist?
Knowledge Management	Which knowledge is necessary to properly prepare the negotiations? How is the prerequisite body of knowledge integrated into the USR-checklist such that Company B is optimally prepared for future negotiations with other developers and buyers of used software? How can other departments at Company B benefit from the prerequisite body of knowledge in subsequent negotiations?

First case The legal situation in 2013 forms the basis for a comprehensive case analysis from a managerial perspective with a specific emphasis on legal issues. The stakeholders are connected through the contract between Companies A and B, on the one hand, as well as the possible subsequent contract between Company B and a potential buyer, on the other hand, the former being of crucial business and legal relevance for the latter. The aforementioned date plays a substantial role in this context: the case takes place in 2013 directly after the verdict of the European Court of Justice (ECJ) in *UsedSoft GmbH v. Oracle International Corp.* in 2012 [8] which is binding for Company A and company B because the European law prevails the national law and therefore limits the freedom of contracting according to German law.

Contract Knowledge: Limits of Freedom of Contracting According to European Law

A European legal framework *sui generis,* which is interpreted by the European Court of Justice (ECJ), exists within the European Union (EU). The legislation of the EU, especially the EU-Regulations, is mandatory and directly applicable in all

member states. The European legislation in terms of Directives is only binding for the goals of the Directive. The legislation and its European interpretation by the ECJ are authoritative on the European level as well as on the national level. The European law prevails over the National law. Therefore, the European law limits the freedom of contracting on the national legislative level within the member states of the EU (see [1], p. 139).

Second case This case takes place in 2007 before the verdict of the European Court of Justice (ECJ) in *UsedSoft GmbH v. Oracle International Corp.* It is based only on German court rulings and highlights the different legal situation before the decision of the ECJ. Since it serves to contrast the first (main) case, only a short risk-analysis is required without checklists.

3.1.2.2 Reader's Tasks

Take the position of Project Coordinator X and process the following tasks:

Task 1: List the information X needs to address the tasks assigned to him. (Level of difficulty: Low)
Task 2: Identify B's risks regarding a possible resale of the used software licenses. (Level of difficulty: Medium)
Task 3: Make a decision whether Company B should start negotiations with Company A. Focus on legal risk. (Level of difficulty: High)
Task 4: Prepare a short negotiation checklist addressing the resale of licenses. (Level of difficulty: Medium)
Task 5: Outline a Used Software Resale (USR) checklist that can be used by Company B for preparing future license agreements with the option of a resale. (Level of difficulty: Medium)
Task 6: How can Project Coordinator X share the knowledge he acquired with his colleagues? (Level of difficulty: Low)

3.2 Decision-Making Process

3.2.1 Identification of the Decision to be Made and Evaluation of the Decision-Making Circumstances

Task 1: List the information X needs to address the tasks assigned to him.
Project Coordinator X can tackle the tasks assigned to him only if he has been provided with all pertinent information (information input):

- First of all, the head of the translation department—who is a member of the project team—must supply the specification of the functionalities of the standard administration software which is to be purchased.
- X has to make sure that the head of the translation department has agreed with the CIO upon the compatibility of the software to be bought with the company's IT infrastructure and the provision of the necessary technical in-house support.
- X has to conduct an analysis of the prospective second-hand buyer's market for the software to be bought from Company A, in particular regarding potential buyers and prices.
- X also requires information about the legal situation which allows a reliable assessment of the risks associated with the resale of second-hand software; to this end, Lawyer Z has been hired.
- Since a possible resale is related to the extremely sensitive topic of outsourcing, X must align the unavoidable information spillage with the information strategy of the executive board on this issue and clarify how the subject can be communicated and handled during the project period.

Task 2: Identify B's risks regarding a possible resale of the used software licenses.

3.2.1.1 Legal Risk

It is essential for Company B to know whether it makes sense to buy a software for EUR 50,000 from Company A for a few years in order to resell it later to a potential buyer for about EUR 25,000. This way, Company B can save about EUR 25,000 and the potential buyer can profit from a used software for half the price of a direct first-hand acquisition from Company A. As already mentioned in the set of facts, the alternative option for Company B would be to outsource the translation activities right away in 2013, which is the time setting of the first case.

If Company A insists on the contractual clause "Acquirer may not assign the rights under this agreement without Company A's prior written consent," then it might be too risky for Company B to resell the used software to a potential buyer. It is unlikely that Company A will give its written consent for the resale of the software because such approval would give rise to similar claims by other customers and thus may endanger Company A's business model.

However, the European law, which supersedes the German law through its **exhaustion principle,** allows the reselling of used software even if a contract states the contrary.

Contract Knowledge: Exhaustion Principle

The German copyright law (section 17 (2)), based on the European Software Directive, mandates the principle of exhaustion of a copyright. This means that as soon as a developer has brought a copyright 'to the market' (sold for the first time), the developer's material interests 'expires', i.e. the buyer is allowed to resell it.

For **more information** on the European Software Directive (Directive 2009/24/EC of the European Parliament and of the Council of 23 April 2009 on the legal protection of computer programs), see http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:111:0016:0022:EN:PDF.

This means that once the software has been brought onto the market by Company A and 'sold' to Company B, the latter can resell it as used software to any potential buyer according to the exhaustion principle.

Software companies, therefore, have taken several measures to avoid being bound by the exhaustion principle and to retain the right to control the distribution of their software programs on the second-hand market. One such measure is the use of software licensing agreements, which grant the licensee the right to use the software only under certain terms and conditions. Generally, software vendors prefer licensing rather than selling software because it allows the developer to retain control over future uses of the copyrighted materials. This explains the intention of Company A to negotiate a licensing agreement and not a purchase agreement.

Before the ECJ 2012 Verdict (see Sect. 3.2.3.1), the general legal situation in the European Union was unclear as to whether the exhaustion principle only applied to a buyer or also to a licensee who does not acquire ownership of the software (which would constitute a sales agreement) but, rather, only the right to use it by downloading it (licensing agreement).

After the Decision of the ECJ 2012, which also interprets the exhaustion principle in binding terms for the German copyright law, it can be taken for granted that even with a licensing agreement, it is legal to resell used software. Nevertheless, the ECJ 2012 Verdict has defined certain conditions under which a legal resale is restricted. That is why Company B has to figure out under which conditions it is allowed to resell the used software to a potential buyer. Company B has also to think about other business models which could limit a resale on the second-hand market and possible strategies which Company A might introduce to this end during the negotiations.

For Company B, the possibility of reselling the used software to a potential buyer therefore depends on the design of the contract concluded between companies A and B. This contract could directly affect the design of the contract between Company B as reseller and a potential buyer. As previously mentioned, the aim of Company A is to curtail the second-hand market as much as possible and to propagate a contract design that is most favorable to its interests. As such, the contract between companies A and B at the point of initial software distribution steers the business options and thus the contractual options available to stakeholders on the second-hand market. In other words, it has a direct impact on the business activities of Company B and a potential buyer. Consequently, Company B has to engage in risk management in order to anticipate the impact of the contractual stipulations set up by companies A and B on the contract concluded between Company B as reseller and a potential buyer on the second-hand-market.

The issue of a legal or illegal resale is of considerable relevance because in the latter case, the potential buyer would not be allowed to use the software acquired from Company B. As a consequence, it would have to bear the direct cost of performing the services through another software as well as the associated opportunity costs (f.e. delays, training, etc.). Furthermore, Company A may file a **cease-and-desist letter** against the potential buyer such that the used software from Company B may no longer be utilized by the potential buyer. In consequence, the potential buyer could then claim warranty against Company B.

Contract Knowledge: Cease-and-Desist Letter
A cease-and-desist letter is usually a notice sent from one natural or legal person to another, urging them to stop an activity the former has deemed illegal (cease) and obliging the latter never to re-engage in that activity (desist). Cease-and-desist letters are frequently utilized in disputes concerning intellectual property. They have different functions: e.g. for starting settlement negotiations, for serving as an impetus for licensing discussions or for taking steps to prepare for a potential lawsuit. It is common to deluge competitors with cease-and-desist letters even for minor instances of noncompliance ([3], p. 411).

3.2.1.2 Commercial Risk

Apart from legal risk, Project Coordinator X has to consider commercial risks in particular, although legal risk in the end may also amount to a commercial risk.

- **Resale price:** Legal and technical uncertainties regarding the usage of used software by a possible buyer may be substantial and will impact the resale price. These uncertainties include the legal permissibility of resale of the used software, integration into and continuous compatibility with pre-existing IT-Systems, warranties guaranteeing software updates, and assurance for service activities. Alongside these uncertainties comes the general market risk relating to developments on the market as well as in technology. In conclusion, there are significant pricing risks, even in the present case of a legitimate sale from Company B to a potential buyer, as well as the de facto possibility of non-usability of the software, all of which warrant a careful analysis of the risk impact on the resale price.
- **Bargaining power of Company B towards Company A and a potential buyer:** The bargaining power of Company B towards Company A depends on whether there is a large number of sellers on the market which can be assumed in this case. Company A, however, has a strong bargaining power because it is in a long-term business relationship with Company B since the latter provides important services to it.
  The bargaining power of Company B towards a potential buyer seems high because there are few sellers of this used software on the second-hand-market, but, on the

other hand, a potential buyer could also buy the new software from Company A. Company B needs to evaluate at which price and under which circumstances it would make more sense for a potential buyer to buy new software directly from Company A. The risk of a weak bargaining power of Company B towards a potential buyer in conjunction with a low price for the used software is relatively high.

- **Method of delivery to a potential buyer:** Delivery of the software might be problematic should it be conducted using a physical storage medium (such as a DVD) due to the legal situation after the ECJ 2012 Ruling. Furthermore, liability problems may arise in the case of a loss of the medium. The delivery of the software is of no concern, however, if the potential buyer is downloading the software from Company A's website.
- **Warranty issues relating to a potential buyer:** Any warranty for the software may be limited for the duration of license usage by Company B such that a potential buyer might not be able to enforce the warranties against Company A, and therefore will turn against Company B since it delivered a defective product and therefore may be in breach of contract.

3.2.1.3 Ethical Risk

First case Essentially, the legal situation is clear: the sale has been deemed as legitimate by the ECJ 2012 Verdict so that no compliance risks exist with regard to hard law; violation of soft law on the account of Company B or a potential buyer is not apparent. The advantages of the resale lie with the potential buyer on the second-hand market, yet disadvantages are shifted to all buyers on the first-hand market as the price for new software will definitely be higher than the price for the used software. Company B will likely have to pay in the future as the second-hand market is now expanding even further.

Second case Since the sale of used software must be considered legally questionable, compliance risks pertaining to hard law arise. This can lead to ethical concerns since the benefits of a legitimate transaction lie solely with the buyer whereas the disadvantages are mutualized via price, i.e. they are transferred to all buyers of new software. However, in this case there are no indications that the market would consider that as a violation of soft law, causing a loss of reputation or giving rise to market sanctions.

3.2.1.4 Operational Risk

Challenges might arise, for example 'delays in the negotiation schedule' or 'lack of control' or circumstances crucial for a legal resale, such as how to make sure that Company B deletes the software from their database.

3.2.1.5 Motivation Risk

The preparations of the negotiations with Company A will make the prospective outsourcing of the translation department a subject of discussion. As outsourcing will deteriorate the conditions of employment for the affected employees, their motivation may

suffer. Such negative effects may also spread to other employees sympathizing with the former or drawing general conclusions about the way Company B treats its employees.

3.2.1.6 Relationship Risk

Company A has provided IT services for Company B for a long time. Because of this long-standing relationship, it has plenty of experience working for and with Company B, knows its key IT players, the respective internal processes, its IT landscape, its corporate culture, etc. For Company B, as a media & communication company, IT services are of particular relevance. If Company B transfers software licenses obtained from Company A against the latter's will and hereby interferes with its crucial business interests, this valuable asset may be damaged or destroyed even if the transfer is deemed legal.

In addition to potential defects, technical and corporate culture issues may negatively impact the business relationship with the potential buyer. The following problems may occur: the software doesn't function or is not fully compatible in the IT-landscape of a potential buyer; the software might not be compatible with the working culture of a potential buyer; or Company B doesn't provide sufficient training for the utilization of the software so that the potential buyer is not able to make use of it with reasonable effort in terms of time and money.

3.2.2 Preparation of the Decision

Based on the identification of the decision to be made and the evaluation of the decision-making circumstances elaborated upon in Sect. 3.2.1, the following set of questions remains as part of the decision-making process:

Risk Management Which risk from the perspective of Company B is most relevant with regard to the purchase of the standard administration software from Company A and the resale of used software to a potential buyer and needs to be controlled through the negotiation checklist?

Knowledge Management Which information must come from different management fields or departments for the checklist (called **input 1**) and which information goes back to such fields or departments before the negotiation starts (called **output 1**)? How is the necessary knowledge integrated into the USR-checklist (Used Software Resale checklist) that forms part of the lessons learned database such that Company B is optimally prepared for future negotiations with software developers like Company A in view of a possible subsequent resale of the used software? How can Y's experience with the checklist improve the handling of the list for best practice so that Company B may profit in future negotiations from the checklist (called **input 2** and **output 2**)?

3.2.3 Making the Decision

Task 3: Make a decision whether Company B should start negotiations with Company A. Focus on legal risk.

3.2.3.1 Risk Analysis Regarding the Legal Issues

Based on the legal information provided by Lawyer Z, X will assess Company B's situation regarding the resale of used software and the issues which must be considered during the negotiations with Company A.

(a) At the time before the ECJ 2012 Verdict (second case), legal risks manifested themselves through diverging verdicts of different courts at the national (German) level on the topic of a lawful resale of used software and especially on the **exhaustion principle** and its application to licensing agreements.

Contract Knowledge: Exhaustion Principle after *Microsoft v. UsedSoft*

In its Verdict on the case *Microsoft v. UsedSoft*, the German Federal Court of Justice found on July 6th 2000 that the trading of software is permissible within the framework of the German Copyright Act [7]. Any contractual mechanisms to restrict usage of the buyer of software are considered exhausted upon sale. Contractual provisions requiring the licensor's approval for resale were also considered void in the case *Microsoft v. UsedSoft* at the regional court level on June 29th 2006 in which the Hamburg District Court (LG Hamburg) found that the principle of exhaustion is deemed as mandatory law and hence cannot be circumvented through the freedom of contracting [9]. Nevertheless, in *Oracle v. UsedSoft,* the Munich District Court (LG München) established on March 15th 2007 that reselling software that had been delivered through an online download is illegal and that exhaustion is only applicable to software delivered via physical media [10].

One key issue of the ECJ 2012 Verdict was the question whether the principle of exhaustion was **mandatory or optional law**. This question concerns the limitation of freedom of contracting through mandatory state law.

Contract Knowledge: Mandatory Law versus Optional Law

Mandatory law (*ius cogens*) is a legal rule that is not subject to contrary (individual) agreements. According to this principle, mandatory law prevails over contractual agreements, such that it cannot be departed from by agreement between the parties concerned whereas optional law (*ius dispositivum*) can be overruled by the contract, which is then given priority.

A legal system will only limit the freedom of contracting for good reasons. It is not sufficient to limit this freedom because of an inequality of bargaining power e.g. between a large and a small company ([6], p. 6).

No definitive judicature existed about these issues before 2012. Therefore, the legal situation and thus the resulting risks for the contractual parties were unclear. The judgment of the ECJ in 2012 eliminated the obscure legal situation regarding the exhaustion principle and its application to licensing agreements as well as the mandatory law issue. This excluded a lot of the risks for the reseller of used software.

As already mentioned under Sect. 3.2.1, however, the resale of used software in the context of a licensing agreement must meet certain requirements in order to comply with the ECJ 2012 Verdict which renders the exhaustion principle mandatory. In this respect, in its 2012 Verdict, the ECJ collated the argumentations brought up in national courts (see [4], pp. 48–50) as to

- whether the transaction occurred via a tangible, physical medium; and
- whether the transaction mirrored the pattern of either a sales transaction or a license conferral.

The court established that the European Software Directive entails that distribution rights of software are exhausted upon sale both for tangible (when the software is distributed through physical storage media) as well as intangible copies (when the software is downloaded from the developer's website). Concerning the particularities of *Oracle v. UsedSoft*, the court determined that by making copies available over the internet in exchange for payment, Oracle exhausted its distribution rights while granting its customers permission to use the software for an unlimited amount of time [8]. It also determined that Oracle's standard terms aimed at prohibiting resale of the product were void. Therefore, a preclusion of the original buyer from entering the second-hand market is not allowed.

In line with the ECJ 2012 Ruling, buyers of a used software license legitimately acquire a copy of the used software and can also legitimately download it from the copyright owner's website without committing a copyright law infringement.

(b) Furthermore, the court determined that the act of downloading software via the Internet in conjunction with the conclusion of a license agreement constitutes an interdependent and therefore "indivisible whole." Even with license agreements of unlimited duration, the licensor and the copyright owner were not allowed to nullify the principle of exhaustion through contractual terms.

The following **limitations to the exhaustion principle** were summarized by the ruling:

- The copy of the software has been acquired through download from a website of the copyright holder;
- The copyright holder pursues a licensing model which grants economic remuneration for the software provided;
- Conveyed licenses grant usage of the software for an unlimited duration;
- Constellations of group licenses wherein a licensee acquires the right to install and use multiple instances of a single copy of software are considered indivisible and therefore cannot be resold partially;
- Upon resale, the original downloaded copy of the software can no longer be used by the reseller.

The ECJ 2012 Verdict gives rise to a new legal situation in which the overall decision evaluation towards a lawful sale of used software is not based on classical licensing law. The court considers the download of software from a website as an intangible utilization for which the principle of exhaustion is not applicable. Nevertheless, the verdict presumes a tangible utilization in general with the consequence that exhaustion can still be upheld.

In summary, some degree of legal certainty has been reached on the subject matter of a resale of used software if the conditions above are respected. When in compliance with the latter, legal risks due to changes in judicature may be considered as low for the second case. Changes in legislature as a secondary legal source are not apparent.

In consequence, the following questions should be integrated into the checklist:

- Has the copy of the software been acquired via download from the copyright holder's website?
- Was the original license granted by the initial buyer/reseller and developer/copyright holder for an unlimited period of time?
- Did the original license agreement between initial buyer/reseller and developer/copyright holder entail remunerative compensation corresponding to the economic value of the software?
- If the original license consisted of multiple copies of the software made available to the initial buyer/reseller, are all copies now resold together?
- Have all copies of the software been removed from the computers of the reseller upon completion of the resale transaction?
- Which substantial law governs the transaction?

(c) Furthermore, the ECJ ruled that maintenance and support agreements are to be considered separately and are therefore not transferrable under the doctrine of exhaustion as is the case for the software itself. Consequentially, **upgrades or patches to the software, or regular customer support** from the developer cannot be claimed by the buyer of the used software unless a new service agreement is made directly with the software developer. This means that a substantial risk to the buyer arises if the used software requires upgrades, emergency patches or any other type of support from the developer during the intended period of usage.

The verdict highlights the fact that the buyer of standard software who wants to resell it as used software has to factor in the above-mentioned functionality and compatibility risks in its price.

(d) The 2012 Verdict of the ECJ has brought about a legal situation which restricts the software developer to impede a license resale upon the initial sale of the license. This also applies if he deploys prohibitive clauses in the sales contract as Company A intends to do in the given case. However, since the introduction of license contracts through the software developer occurs with the intention of preventing resale on the second-hand market, **new business models** might arise in order to adapt to the need of after-sales distribution and the associated risks. Therefore, the reseller's and the buyer's risk would be completely different if the software developer tried to

circumvent the ECJ 2012 Ruling through new business models aiming to keep the second-hand software market as small as possible. Project Coordinator X has to take into account such risk for Company B when he outlines the negotiation checklist.

To optimize their interests while still maintaining compliance with EU regulations, directives and the ECJ 2012 Ruling, developers may devise alternative distribution methods such as

- formulating contract terms that closely define permissible resale conditions,
- implementing a selective distribution system,
- limiting support to the initial licensee,
- limiting support to a short duration after the sale of the license,
- devising a separately priced support service model for resale software owners, and
- controlling license validity and product accessibility through a software-as-a-service business model underscored by a continuous validation registry.

The developer may also, if economically and strategically appropriate, develop similar new software, thereby making the older version obsolete and consequentially allowing for an easier termination of support and update services for the older version.

Finally, the legal consequences of an illegal resale of the used software have to be addressed here. As mentioned above, Company A (developer) may file **a cease-and-desist letter** which prohibits the buyer from making use of the acquired second-hand software. In response, a buyer could file a warranty claim against Company B since the latter did not deliver what was promised in the contract.

3.2.3.2 The Decision

(a) **Second case:** As mentioned above, the legal situation was unclear before 2013. Therefore, from the legal view point, it would be very risky for Company B to resell the used software to a potential buyer. If the legal risks are compared to the savings of roughly EUR 25,000 in relation to the annual revenues of Company B of EUR 50,000,000, entering such legal risk is not really justified in the light of the marginal prospective economic benefit. On the other hand, it was possible to minimize the existing legal risk in 2007 if the software was transferred via a physical storage medium to a potential buyer. As described above, in 2007 the Munich district court held that this approach was a permissible method for the resale of used software. As this, however, represents a single verdict at the regional level and, because the decision is only binding for the litigants, a significant level of risk remained in 2007. Therefore, in summary, a resale of the used software was not recommendable, and Company B should refrain from initiating negotiations about the standard administration software with Company A.

(b) **First case:** Due to the alleviation of legal risks on software purchases and resales by the ECJ 2012 Verdict, Company B may take the risk of a resale of the software in 2013 transactions if it adheres to the limitations set forth by the ECJ 2012 Verdict. In

order to communicate this knowledge and emphasize compliance, these limitations should be included in the negotiation checklist. From a legal point of view Company B may engage in negotiations on the sale of the standard administration software since there is little legal risk involved.

3.3 Implementation of the Decision

3.3.1 External Implementation

Task 4: Prepare a short negotiation checklist addressing the resale of the licenses. The negotiation checklist with a special focus on the option of reselling the used software to a potential buyer is intended to serve Y as a guideline for the negotiations with Company A regarding the standard administration software. It is the result of the CM process steps plan and draft which will also be analysed in the context of knowledge management (see under Sect. 3.3.2).

The checklist must outline the negotiation topics weighted according to their relevance in relation to Company B's strategic goals and its transaction targets. For this analysis, Project Coordinator X can use the following work aid:

Work Aid: Classification of Negotiation Topics

Since many issues can arise in negotiations, it is important for both parties to have an agenda regarding the urgency of specific issues as well as the willingness to compromise or to go for package deals. The classification given hereunder is common in practice:

A **deal breaker** is reached when, for one party, further negotiations no longer make any sense (crossing the red line) because an essential negotiation objective is no longer achievable.

A **major topic** is defined as a central negotiation objective which, if ignored, wouldn't completely be inacceptable, but would in turn require major 'concessions' from the other party.

A **minor topic** relates to a subordinate objective which is only of minor relevance for the overall negotiation and may easily be given up.

Based on the legal advice of Lawyer Z as outlined under Sect. 3.2.3.1, Project Coordinator X will classify the identified risks according to the categories of the work aid. The resulting negotiation checklist (for the first case) also contains the contractual risks that were deemed less important, in particular Company A's options for termination and for acquiring injunctive relief against a potential buyer. These risks may still be analyzed during the course of the negotiation (Fig. 3.1).

NEGOTIATION CHECKLIST

Deal Breaker

- ☐ The copy of a potential buyer must be downloaded from the right holder's (A's) website.
- ☐ The right holder A must provide B with a license to use that copy for an unlimited period of time as proven by a copy of the contract between A and B for a potential buyer.
- ☐ The right holder A must receive a fee that serves as remuneration corresponding to the economic value of the downloaded copy as proven by a copy of the contract between A and B for a potential buyer.
- ☐ Group licenses, those wherein the user B obtains a single copy of the computer program along with a license to subsequently install it in duplicate for a fixed number of times, must not be divided such that only parts of these duplicate copies are resold. Consequently, the contract has to establish that B can prove that the software sold does not qualify as group license. Otherwise, B has to certify that it is selling the entirety of the group license and does not retain any copies.
- ☐ The original acquirer B of the copy of the computer program can only benefit from the right to resell if he has made the downloaded copy on his own computer unusable at the time of resale. A written confirmation by Company B not to use the software any more must be issued.
- ☐ Does A have a right to terminate against B for the scenario that B resells the software to a potential buyer? Can a potential buyer claim breach of warranty against B?
- ☐ Applicable law is German law.
- ☐ Does A intend to develop similar new software in the near future, thereby making the older version of B obsolete and consequently allowing for an easier termination of support and update service for the older version of a potential buyer, resold by B?
- ☐ Does A want to include in the contract between A and B alternative distribution methods which are compliant with EU and German law and with the ECJ Verdict 2012 but excluding a resale of the used software by B? E.g.: is it acceptable to A to
  - ☐ formulate a contract term that closely defines permissible resale conditions,
  - ☐ implement a selective distribution system,
  - ☐ limit support either to the initial licensee or to limit support to only a short duration after sale of the license,
  - ☐ devise a separately priced support service model for owners of resold software,
  - ☐ control license validity and product accessibility through a continuous validation registry, f.e. by following a software-as-a-service business model.

Major Topic

- ☐ Have substantial risks for a potential buyer pertaining to the usability of software been considered in negotiating the purchase price for the new software for B?
- ☐ Has there been an evaluation to determine the price at which it would be more beneficial for a potential buyer to directly buy new software from Company A?
- ☐ Is a potential buyer entitled to both legacy and future updates as well as support service?
- ☐ Is it necessary for a potential buyer to negotiate with Company A about updates or support services?

Minor Topic

- ☐ Software insurance.

Fig. 3.1 Negotiation checklist

This case study only focuses on the preparation of negotiations relating to the key points of a contract draft that will likely be presented by Company A. Depending on the distribution of bargaining power, the draft could also be presented by the buyer, here Company B, as it is a long-term client of Company A. However, the latter scenario is not very probable.

The CM process step draft, comprising the negotiation itself, the contract drafting and the contract signature (closure), also does not require any further examination of the implementation of a signed software contract, its monitoring, and evaluation.

3.3.2 Internal Implementation

The risk analysis brought to light that the purchase of the standard administration software may affect crucial interests of Company B, in particular as regards to the business relationship with Company A and considerations regarding the outsourcing of translation services. It is therefore necessary for Project Coordinator X to ensure that his course of action is in line with corporate goals and is approved by the top management.

All persons or functions of Company B mentioned in the Used Software Resale (USR) checklist below must be available before, during and after the negotiation for further data input (information input) and must be informed about the negotiation outcome (information output).

Since the transaction under consideration is a standard process for the procurement department, no further implementation challenges arise. In particular, Y's authority to negotiate and sign on behalf of Company B is beyond doubt since, according to German law, Y as the head of the procurement department has either an actual or at least an apparent authority to sign all types of procurement contracts.

3.4 Process Optimization

Knowledge management serves to provide the relevant information necessary for company processes (input and output) and is essentially the backbone of contract handling. It enables Company B not only to optimally deal with the issue at hand but also to be properly prepared for the negotiation of future contracts **(first case)**. In order to fully profit from the negotiation checklist, it must be integrated into the workflow of Company B (knowledge management). In this respect, the following questions need to be addressed:

- How is the necessary knowledge integrated into the USR-checklist such that company B is optimally prepared for future negotiations in respect of a potential resale of the used software?
- Which information for the USR-checklist (input 1) must come from the various company functions or from external sources and which information goes back (output 1) before the negotiation starts?
- How can the experiences of Y and X with the negotiation checklist be used for developing a best practice for the handling of the checklist so that Company B may profit in future negotiations from the USR-checklist (input 2 and output 2)?

3.4.1 Used Software Resale Checklist (USR-Checklist)

Task 5: Outline a Used Software Resale (USR) checklist that can be used by Company B for preparing future license agreements with the option of a resale.
Based on the above questions, X and his team will design the following RUS-checklist (as a process step result) to structure the future purchase of new software and the planned resale of used software to a potential buyer. The USR-checklist integrates the issues already addressed in the negotiation checklist (presented in Sect. 3.3.1) into the workflow of Company B as depicted in Figure 3.2.

USED SOFTWARE RESALE (USR) CHECKLIST

- ☐ Y from Company B is responsible for the contract negotiation.
- ☐ The checklist for the negotiation was proposed by Y, prepared by Project Coordinator X, and checked by Lawyer Z.
- ☐ Company B's IT-department will check
  - ☐ that all documents needed by a potential buyer (such as the license agreement, invoices, license certifications, etc.) are available and handed over upon later resale,
  - ☐ that the right to use and the restrictions on use of the software as defined in the contract are acceptable to a potential buyer (also checked by the Project Coordinator X).
- ☐ Project Coordinator X will check that a potential buyer gets a written confirmation issued by Company B that the latter will no longer use the software.
- ☐ A potential buyer should receive an updated version of the software as well as an acceptable software support service package.
- ☐ The IT-department will check the general compatibility of the software's current version at the time of sale and create an update schedule prognosis based on A's update history.
- ☐ Y should inform himself about A's new business models, pricing and bargaining power in preparation for his negotiation.
- ☐ Lawyer Z should share information with Y about the special legal circumstances with further details about the court rulings and about the general legal background (f.e. Does A have a right to terminate against B if B resells the software to a potential buyer? Can a potential buyer claim breach of warranty against B?).
- ☐ The IT-department must conduct background research to determine the decision threshold between procuring used software from B or new software from A (f.e. determining embedding compatibility into a potential buyer's IT-landscape).
- ☐ Project Coordinator X has to make sure that the negotiation checklists and all new points of discussion addressed in process step planning and drafting are filed in Company B's lessons learned database and that all other involved persons of Company B like Y and the CIO have access to the data relevant for their tasks.
- ☐ Project Coordinator X has to make sure that the USR-checklist is filed in the lessons learned database (input 1) before the negotiation starts and that the involved persons have access to the checklist (output 1). X has to enable Y to improve the checklist during the process step planning and drafting and based on the recommendation of Y to give access to the lessons learned database to other departments of Company B (input 2 and output 2) so that they can use the checklist for their own negotiations (sharing the information within the company).

Fig. 3.2 USR-checklist

3.4.2 Knowledge Dissemination

Task 6: How can Project Coordinator X share the knowledge he acquired with his colleagues?
X and his team have been assigned the task of creating knowledge on the project's subject and to sharing it to enable Company B's negotiators to profit from the lessons learned repository of the negotiation checklist, the USR-checklist, and further knowledge databases. X can break this task down into three steps:

- **Knowledge administration:** All relevant information provided by Company B's employees as well as by externals must be collected and filed in the lessons learned database, in particular all insights gained during the negotiation of the purchase agreement with Company A. With software being the item of purchase or resale, pertinent business, legal and technical information must be collected and made available to all relevant departments in Company B.
- **Knowledge evaluation:** Data capture must be based on a procedure developed by X (due to his experience as project coordinator) and should aim to achieve a holistic view of the transaction. This will also enable a thorough analysis of the information which, in this case, may encompass general market intelligence, pricing, and possible business models for the selling and reselling of used software. Technical questions arise with regard to the availability of virtual goods—such as software in this case—and the legal context of such transactions must be considered and integrated into the evaluation of knowledge.
- **Knowledge sharing:** Finally, the logical sequence for the integration of both the internal and external stakeholders as well as their involvement in the negotiation needs to be "made visible." This way, Company B's employees may be made aware of the experience and knowledge accrued by X and thus apply it to other projects. This will also allow for meaningful feedback on the applicability of this shared knowledge to current and future activities. For example, the structure of the guidance on the practical use of the checklists is to be made accessible as a template for negotiations via the lessons learned database and training for sales of used software is to be conducted for affected employees and the negotiation team.

3.4.3 Process Optimization Options

Project Coordinator X must also question the appropriateness of Company B's information infrastructure. He has, for instance, to consider whether all software contracts need central administration and the outline of the knowledge databases is sufficient for Company B's purposes. If not, he must bring the shortcomings to the attention of his superiors in order to avoid waste of resources, reduce legal risk, and enable the adaptation to the continuing fast-paced developments in the software market.

Finally, he may consider it appropriate to stress the need to periodically monitor the legal development (legislation and jurisdiction) in the field of licensing and other related business models, f.e. through a consultancy contract with Lawyer Z.

3.5 Actual Execution

In the actual case, Y discussed the recommendations made by Project Coordinator X as regards to the purchase of the standard administration software with the Company's owner-manager O before getting in touch with Company A. The considerations soon focused on two major issues: the risks involved in the purchase and resale of the software and the possible outsourcing of the translation department. After thorough discussion of the different aspects to be taken into account, the owner-manager decided that the option of a resale of the used software licenses with a possible gain of perhaps EUR 25,000 did not justify putting the relationship with Company A at risk—in particular since the price risk for selling the used software at the second-hand market was hardly assessable and the discussion among the workforce about outsourcing the translation department would be fueled again. Instead, O took the demand for a new software for the translation department as further inducement to push ahead with its outsourcing. At the same time, he advised Y to always consider a possible resale of the software in the future when preparing negotiations for the purchase of a new software.

Beyond the actual execution of the case at hand, however, some general remarks on the legitimate resale of used software are possible: The legal situation before the ECJ 2012 Verdict **(second case), especially before 2008,** was uncertain; legal risks manifested themselves through diverging verdicts of different courts at the national level on the topic of used software resales. Since no definitive judicature existed, legal risks arising from national legislature could materialize. Guidelines at that time had to focus on the developer and its legal situation, the means of transfer (e.g. the physical form of transfer), and the conditions under which the transfer from reseller to buyer had to take place.

After the ECJ 2012 Verdict **(first case)**, buyers of used software licenses could legitimately acquire a copy of the used software and could also legitimately download it from the website of the software seller without committing copyright infringement. The transaction was now more focused on the reseller and third-party buyer and the conditions under which the used software could be lawfully resold.

Consequently, Company B's decision in favor of reselling the used software to a potential buyer, based on legal reasons, became more favorable since the ECJ 2012 Verdict. It reduced the risk of Company A filing **a cease-and-desist letter** against a potential buyer with the consequence that the used software bought from Company B could no longer be used by the third-party buyer, which in turn would result in its claim against Company B for breach of warranty.

Every software developer, however, will have an interest—based on the experiences gained with its clients and the trend in second-hand sales increasing at that time—in

reducing the second-hand market as much as possible by developing new business models. Therefore, Company A might contemplate implementing technical devices, for instance a validation key to activate the software on a computer, which are commonly utilized nowadays. It could also consider legal/business models which make the operation of the used software difficult or impossible, for instance license agreements limiting support either to the initial licensee or limiting support to only a short duration after sale of the license. Another alternative would be the provision of the software through a cloud license, as is commonly done today.

These contemplations, however, have no direct effect on the decision-making of Company B in our case. The only scenario which might have an impact on Company B would be if the developer stops the production of a special software, such that updates for this software will no longer be available.

To summarize: The managerial and legal risks coming from the jurisdiction have been considerably reduced since 2012. As mentioned above, following the Decision of ECJ in 2012, the legal viewpoint of the purchase of used software nowadays is unequivocal: The purchase of used software is legal under precisely defined circumstances. Thus, legal risks in case of changes in judicature may be considered as low. Changes in legislature as a secondary legal source are not apparent.

The main focus before the ECJ 2012 Judgment **(second case)** was primarily on the legal risk and the functionality/compatibility of the used software within the technical environment of a potential buyer, involving questions such as: How long are updates available? For how long does a potential buyer want to use the software? However, the technical questions and the development of new business models from the developer side will be quite decisive for Company B and a potential buyer.

After the ECJ Judgment of 2012 **(first case)**, a certain degree of legal certainty has been reached on the subject matter of used software for all three involved parties (Company A, Company B and a potential buyer). Furthermore, it has become more important to which extent a resale is still technically feasible (e.g. does a validation key exist?) and whether the business model allows for a purchase of used software (e.g. time limits for the use of the software, support, updating). The business purposes of Company B and a potential buyer, the bargaining power of Company B towards a potential buyer or towards Company A, or price issues become the main topics of discussion before and during the negotiations.

3.6 Learning Outcome

3.6.1 CM Value for the Case Study

The CM Model provides a structured analytic framework which can be used for dealing with the case study's tasks. The CM process steps plan and draft are especially relevant in preparing for the negotiation of a contract regarding the purchase of new software and

reselling it later on the second-hand market. The management fields concerned are risk management and knowledge management. Based on the interaction of the mentioned management fields and process steps, it can be deduced how the purchase contract must be designed to suit a subsequent resale of the used software on the second-hand market. This way, the purchase contract steers the design of the resale contract for the used software and works as a management tool.

The CM Model directs attention to the risks of licensing agreements, especially their limits for reselling the used software, and highlights how they can be assessed and how tools like checklists can be implemented in order to reduce such risks. The questions which arise in this context and which can be solved with the help of the CM Model are:

- Which steering function does the contract between Companies A and B have with regard to the transaction and the contract between Company B and a potential buyer?
- Which information (knowledge) can be pulled out of these fields for the negotiation while bearing in mind the risk considerations of Company B's various departments?
- What information is already available in Company B's departments and can give a risk management capability and readiness assessment of the already available managerial organization and preparatory steps regarding the purchase of the new software and its resale on the second-hand market?
- What effects will the preparation of negotiations and the negotiations themselves have on the four major CM management fields with regard to future risk behaviour when buying new software with the intention to resell it on the second-hand market?

The CM Model allows for a clear understanding of the interaction between the aforementioned management fields and process steps and delineates the progression from negotiation planning to the actual negotiation preparation while considering commercial, legal, ethical, and operational aspects. The checklists supporting the contract negotiations do not only outline negotiation goals but can also be seen as operating guidelines and a controlling instrument for Company B with regard to the complex topic pertaining to buying new software and reselling it on the second-hand market.

Overall, the CM Model specifically highlights the management function of a contract and how contract design can be adapted to a changing environment, in the actual case to changing jurisdiction. Through contract design, new business models are realized while the subsequent available options of the contracting parties are delineated simultaneously. Even subsequent follow-up contracts and business with third parties (here, the contract between Company B and a potential buyer) may therefore be managed directly or indirectly through the content of the initial contract (here, the contract between Companies A and B as well as the associated business models).

Finally, this case study demonstrates the relevance knowledge management has on the networking of multiple departments within a company in the CM Model framework, such as how the necessary information should be integrated into the workflow of the company and how information can be transformed into knowledge and shared with other departments.

3.6.2 Case Study Value for the Reader

The reader will **acquire business and contract-related knowledge,** in particular with respect to the following points:

- Development (since 2000) of the legal and, in consequence, managerial conditions of the purchase of new software with the intention to resell it later on the second-hand market;
- Distinction between purchase contract and licensing contracts in the context of standard software procurement;
- Conditions under which the resale of used software licenses on the second-hand is legal;
- Defining the conditions under which a licensing contract excludes resales on the second-hand market;
- Development of new business models categorically excluding the purchase of used software on the second-hand market independent of currect legal frameworks;
- Circumventing the ECJ 2012 Ruling in compliance with the EU and German law through new business models while aiming to keep the second-hand software market as small as possible;
- Steering effect in the design of a purchase contract for new software on the resale contract for this software.

The reader will **learn how to prepare software negotiations** with the help of risk and knowledge checklists and therefore gain a deeper understanding of the managerial and legal aspects of such a case. He or she will know how to deal with a changing and, to a certain extent, uncertain legal background in negotiations and understand to which extent the changing legal background has a direct effect on the business models of software developing companies. Furthermore, the reader will comprehend how software companies try to adapt to the changing legal conditions in order to exclude or at least to reduce the second-hand market for software and that these issues may determine the content and the strategy of negotiating with buyers of new software.

The reader will accrue a **better understanding of the management system**, especially the meaning of knowledge management and risk management for the purchase of new software and the reselling of it on the second-hand market as well as the interaction between different management fields and the Contractual Management cycle (here, CM process steps plan and draft).

Finally, the reader will gain **decision-making competence** regarding the purchase of new software and reselling it on the second-hand market. In particular, he or she learns how to reflect on the questions regarding how to develop and design checklists for the purchase of new software and its reselling and how to adjust the management processes in order to better align them with the risk profile of licensing agreements for negotiating the purchase of new software.

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The Tricky Boiler Case—Managing Scope Issues in Project Execution

4

Ralph Schuhmann

Contents

R. Schuhmann (✉)
Ernst-Abbe-Hochschule Jena, Jena, Germany
e-mail: Ralph.Schuhmann@eah-jena.de

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Abstract

This case study deals with three situations of unforeseen events disturbing the execution of a large-scale project. It highlights the many functions a contract has to fulfil under such circumstances, its impact on project management as well as the effects of its working environment on contract implementation. Since projects are highly dynamic, the contract's main purpose is to organize an orderly progression of the project while maintaining the substance of the agreement reached by the parties. The contract thus serves as a manual for project execution under unexpected conditions, and the stakeholders' potential course of action will largely depend on its content.

The conflicting necessities and interests in cases of project scope issues are addressed in particular by the concepts of change, disruption, and additional order. Each of them entails complex processes: In terms of organization and communication, they cover a considerable number of fields of management and concern a variety of departments and management functions; at a material level, decisions will be made in a somewhat opaque interplay of explicit legal rules, implicit social norms, and business objectives. The linking parameter for the various processes, however, will be the construct 'risk' and considerations of risk management.

Keywords	Scope of work, disruption, Force Majeure, additional order, variation, change order, change request, claims management
Principle management topic	Change
Institution	Large company, private, profit
Subject of management	Transaction
CM process step	Draft, implement
Management field	Project management, risk management, change management, claims management
Contract type	Project contract

Editor's Note: For a full understanding of the CM Model's practical benefit for the case study, the reader may have to peruse at least sect. 1.4.4 and 1.4.5 of Part I. The keywords used above to characterize the area of contract application are explained in the key system preceding the case studies in Part II.

4.1 Challenge 1 (Initial Case)

4.1.1 Set of Facts

Estonia Power AS (EP, Purchaser), a company registered in Estonia, is an energy supplier operating a number of power plants in Estonia. Industry and Power Services GmbH (IPS, Contractor) is a company active in the field of conventional power plant construction and registered in Germany. On November 15, 2017, EP has placed an order on IPS for the boiler lot of the project "Overhaul Units A1 and A2 Valma Power Plant." Both units are lignite fired and went into operation in 1988. The contract (Contract) consists of various documents, in particular the Agreement, ORGALIME Turnkey General Conditions (GC) and Appendix II. Start of IPS's on-site construction work has been scheduled for March 1, 2018 and mechanical completion for September 15, 2018. Units A1 and A2 shall resume operation on November 1, 2018.

The dismantling work at the pressure system of boiler A1 was commenced on March 5. The following day, insulation materials containing asbestos were discovered in the area of the piping system.

Explanation: Asbestos
Until the 1980s, asbestos was largely used in all types of industry. Called the "miracle fiber," it was in widespread use in particular for insulation against heat. Since then it has been banned in many countries because of its extremely hazardous effects. Exposure to asbestos occurs through inhalation of fibers released in the air and may cause lung cancer, mesothelioma, cancer of the larynx and ovary, and asbestosis (fibrosis of the lungs).

IPS's project manager P immediately ordered a halt in construction, removed the workforce from the work area, and made a notification to the Purchaser which informed the competent authorities. P now has to consider the consequences this incident will have for IPS and the measures that will need to be taken.

4.1.2 Operating Procedure

4.1.2.1 Author's Explanations

In the case at hand, the transaction—here a project—is the subject of the management activities. The transaction is in the post-award phase of the contract, which corresponds to the **Contractual Management (CM) process step implement**. Thus, the contractual parties are not free in their management decisions but partially bound by legal rules and, in particular, by the Contract.

A contract may restrict but also create decision-making options. In this respect it must be seen as a **management instrument**. Project manager P's scope of action thus depends

largely on the Contract. The more completely and effectively risk management has identified and mitigated all contingencies of the project, the better the Contract and the better the position of IPS. The results produced by the Contract thus give testimony to the quality of IPS's **risk management** during the CM process steps plan and draft since all major disturbances in project execution can and must be captured and processed as risks.

Project manager P finds himself in a situation in which he has to make a decision based on a multitude of factual and legal information that should be found in a well-established **knowledge management system**. It has to provide the required data in-put with respect to the questions whether there are binding legal rules guiding the decision process and outcome and how they are to be interpreted, just as it has to make available information on IPS's strategy, the business partner, EP, the personality of his negotiation partner, the relationship history, etc. To this end P will be closely involved in the information and communication processes of the respective functions of IPS. The information out-put dimension of the **knowledge management system** will ensure that all of IPS's functions concerned are provided with relevant information on events within P's scope of responsibility as well as on decisions he has made.

4.1.2.2 Reader's Tasks

Take the position of IPS's project manager P and process the tasks listed hereunder.

Task 1: Make a decision whether IPS is responsible for the removal of the asbestos-contaminated materials. (Level of difficulty: Medium)
Task 2: List the effects the suspension of work may have on IPS. (Level of difficulty: Low)
Task 3: Find out whether IPS can claim for compensation for the losses it suffered from the incident. (Level of difficulty: High)
Task 4: Make a decision whether to assert a claim for compensation against EP. (Level of difficulty: Medium)
Task 5: Explain how P has to proceed if he decides to assert a claim against EP. (Level of difficulty: High)

Consult the contract displayed in the Appendices where necessary. It includes the relevant excerpts from the Agreement, GC and Annex II.

4.2 Decision-Making Process

Task 1: Decision whether IPS is responsible for the removal of the asbestos-contaminated materials.
In the case at hand, IPS and EP are not free in their decisions but bound by legal rules. Such rules are provided by state law (more precisely by contract law) and by the contract the parties have agreed upon. Non-compliance with legal rules is under the threat of enforcement by state authorities and thus exerts considerable pressure to obey such rules.

Because of the **Principle of Freedom of Contract**, contractual provisions take precedent over contract law in the vast majority of cases.

Contract Knowledge: Principle of Freedom of Contract
It is a universal principle that the parties themselves are free to establish the rules governing their relationship. Thus, in principle, contract law is optional, i.e. can be replaced by a provision on which the parties agreed. Contract law will only be mandatory if one of the parties is not in a position to efficiently protect its own interests in negotiations.

In order to make a decision regarding the responsibility for removing the asbestos-contaminated materials, P therefore has to find out whether the Contract addresses the issue at hand and, if so, how such provision must be interpreted.

One of the most familiar functions of the contract is to specify the parties' rights and obligations. In project contracts, the description of the work of the contractor is given particular attention. The entirety of such delineations is termed **scope of work**.

Contract Knowledge: Scope of Work
In business related to technical products, the contract will explicitly state the nature, quality and performance of the product or the work to be executed by the contractor. This part of the contract is called **scope of work**. It can be very detailed and run over hundreds of pages. All work not included in the scope of work is not covered by the contract price and, accordingly, is not required of the contractor.

If the transaction has been properly prepared, the contract can be expected to address all foreseeable issues of major importance relating to the interests of the parties. Such *ex ante* approach relies on a well-established risk management system in both the contractor's and the purchaser's internal organizations. Risk management will identify risks, assess their probability and possible impact and then implement and monitor the devices deployed to reduce the risks or their impact. Whenever such 'risk responses' encroach on the legal position of the business partner, they need support through contractual authorization. If work is to be performed in a power plant which has been constructed in the 1980s, the usage of asbestos is highly probable and constitutes a common risk that needs to be taken into account. Consequently, a carefully prepared contract will stipulate in its scope of work whether the contractor is responsible for handling potentially asbestos-contaminated materials or whether this will be done by someone else.

(a) The Contract concluded between EP and IPS deals with the scope of work in Article 3 Agreement and in sub-clause 62.9 Annex II. According to Article 3 Agreement, all work the contractor has to perform is mentioned in the technical specification laid

down in Annex II. Sub-clause 62.9 Annex II states that the handling of asbestos-contaminated materials is excluded from the contractor's scope of work.
A positive stipulation of a contractual party's responsibilities, as a rule, implies a negative statement on what it has not to do and vice versa. In this respect, the contract is a zero-sum-game: If the work is not to be performed by the contractor, then it is the purchaser's responsibility to deal with it.

(b) A contract, however, may also describe work to be performed in an indirect way by using a so-called **all-inclusive clause**.

Contract Knowledge: All-Inclusive Clause
If the purchaser provides the technical specification which describes the contractor's scope of work in detail, he runs the risk that at some later stage it may become apparent that the technical specification is incomplete. In this case, he has to pay for the additional work or for any necessary changes. In order to transfer such scope risk to the contractor, the purchaser may insist on the inclusion of an all-inclusive clause in the contract during the CM process step draft.

Sub-clause 4.2, second sentence GC represents an all-inclusive clause since it expands the scope of work to all tasks necessary in order to fulfil the operating characteristics and performance requirements even if such tasks are not mentioned in the Contract. An all-inclusive clause, however, only deals with work not explicitly mentioned in the technical specification. Since clause 62.9 Annex II clearly excludes all asbestos-related work from the contractor's scope of work, sub-clause 4.2 does not apply.

Outcome It is not IPS's responsibility to perform the asbestos removal work. Thus, it is up to EP to handle this task either by itself or by outsourcing it to a contractor.

Task 2: Effects of the incident on IPS.
While EP takes care of the asbestos abatement, IPS has to stop its work and wait until the hazardous materials have been completely removed from the work area. This may cause various disadvantages to IPS such as:

- Removal of workforce from the site: additional demobilization, mobilization and transport costs;
- Waiting: producing labor and machinery costs but being unproductive;
- Speeding-up: extra costs because of overtime, extra shifts, additional workforce, additional machinery etc.;
- Longer presence at the site: manpower cannot be used elsewhere and hereby produce a profit, extended need for site facilities, conservation costs;
- Delay of completion: deferred payments affecting IPS's cash-flow, financing and securities.

Task 3: Possibility to claim for compensation.
In view of the foreseeable losses due to EP's failure to provide for the asbestos removal, P wonders whether IPS can claim for compensation against EP.

P's findings will largely depend on the content of the Contract. IPS's knowledge management system will provide him with all relevant information concerning the applicable legal provisions and enable him to sort out (a) whether IPS can hold EP responsible for the incident, (b) under which conditions IPS can assert a claim and (c) what it can claim for.

(a) Although IPS has no contractual obligation to perform the asbestos removal work, it nevertheless may have to bear the negative impact of the incident without the right to compensation if the asbestos contamination were considered an event of Force Majeure.

Contract Knowledge: Force Majeure
Concepts of 'Force Majeure' under state law can differ according to the relevant jurisdiction. In very general terms, Force Majeure relates to an external event that is beyond the control of the parties and makes performance of one or both of the parties temporarily or indefinitely impossible. In such a case, each party has to bear its own risk and cannot claim for financial compensation.

According to the Principle of Freedom of Contract, the parties can modify the state law on Force Majeure through contractual provisions which may relate to its prerequisites (i.e. giving a definition of Force Majeure or listing events of Force Majeure), its consequences (e.g. granting a right to terminate) or the procedures the parties have to follow in the case of such an event. The definition of Force Majeure, as well as the listing of specific events, is an important ex ante instrument to transfer risk. It is a common practice to attribute risks to Force Majeure although they clearly would not qualify as such under state law.

For **further reading** on Force Majeure and Force Majeure clauses see [5]. For an **instructive arbitral award** on Force Majeure see [13].

In the given case, the Contract deals with Force Majeure in clause 24. Asbestos, however, is not mentioned as an event of Force Majeure just as it is not covered by the definition of Force Majeure which requires an event to be beyond the control of the parties. As can be seen from sub-clause 62.9 Annex II, the parties were aware of the asbestos issue when concluding the contract. Since they were able to handle i.e. to remove and thus to control it, the discovery of the asbestos contamination does not match the given definition.

(b) When signing the contract, the parties agree to the performances they are required to accomplish, but they also implicitly agree that each party shall commit due acts of cooperation and refrain from acts or omissions unduly impeding the other party's legitimate activities. A contravention of this legal demand is called **disruption**.

Contract Knowledge: Disruption

The large number of companies involved in projects and the interdependence of their contributions and activities make it highly probable that a flaw of one company negatively impacts the work progress of another company. Such incidents are covered under the respective state law.

- Common law jurisdictions frequently refer to it as '**disruption**' which AACE International ([1], p. 9) defines as "an action or event which hinders a party from proceeding with the work or some portion of the work as planned or as scheduled."
- The German legal concept of '***Behinderung***' designates an act or omission of a purchaser that makes it impossible for a contractor to achieve the project goals in the manner, and under the conditions, agreed upon.

Disruption may occur whenever the purchaser fails to perform a due act of cooperation such as providing permissions, engineering, data and test scenarios, owner-furnished items etc. and leads to decreased productivity on the part of the contractor, for instance because he has to wait.

The contractor's remedies in such cases and the conditions under which they are applicable depend on the respective state law. In general, the contractor can claim for the reimbursement of additional **costs for the so called Stand-By Time** and the granting of additional time (so called **Extension of Time**).

According to the Principle of Freedom of Contract, the contractual parties may reasonably deviate from the respective state law concept. They may do so by defining the conditions and the consequences of disruption as well as the proceedings the parties have to follow. Thus, contract provisions on disruption serve to proactively deal with the coordination risk of the purchaser.

For **further reading** on disruption see [2], pp. 762 et seq. For an **instructive court decision** see County of Galveston v. Triple B Services, LLP (2016), [12].

IPS is hindered because EP did not observe its contractual obligation to deal with the removal of the asbestos-contaminated materials or, in other words, because it did not ensure that the work area was prepared for IPS's work, thereby causing disadvantages to IPS.

(c) Sub-clauses 6.5 and 7.6 GC stipulate the conditions under which IPS can claim for cost and time compensation due to the disruption and outline the claims it is entitled to against EP.
   – GC, sub-clause 6.5, first paragraph, item a) grants the contractor additional time in cases of failure of the purchaser to perform any of his contractual obligations correctly and on time. In the case at hand, it was the Purchaser's responsibility to remove the asbestos-contaminated materials which he failed to do, thereby

hindering IPS's work. Thus, IPS can claim for **Extension of Time** according to the time it lost because of the incident.
- Sub-clause 7.6, first paragraph GC stipulates the right to financial compensation in the cases mentioned under 6.5, first paragraph a) through h) GC. The costs for the **Stand-By Time**, which IPS can claim for, are specified in the second paragraph. However, IPS can only claim for the reimbursement of costs and expenses, not for the loss of profit mentioned above under Task 2, last bullet point.

Task 4: Decision whether to assert a claim.
After identifying the responsibilities and the action IPS can take regarding the asbestos incident, project manager P has to decide on an appropriate course of action.

Contract Knowledge: Contract and Decision-Making in Business
Contract prepares the ground for decisions in business but it is only one factor among others. Mnookin and Kornhauser [9] aptly designate the **guiding function** of law in situations of conflict by coining the phrase "bargaining in the shadow of law." Collins [4] stresses that, regarding transactions, three factors are to be considered in the decision-making process: **the deal**, **the relationship and the (legal) rules**. Relational contract theory underlines that business behavior is not only governed by explicit legal rules but also by **implicit social norms** like ethical or moral standards, business practice, status, sympathy and loyalty. Relationship management theory [11], in turn, emphasizes the importance of **long-term orientation** and soft factors like growth in institutional knowledge.

Hence, project manager P has to consider both the opportunities and the risks associated with the various options available. He will take into account in particular the price quality of the project, the additional costs caused by the incident, the further need for cooperation to successfully complete the project, but also the history and prospective future of the business relationship with EP. He will also take into account IPS's position because of possible claims from EP for breaches of contract committed by IPS.

Conclusion Given EP's obvious responsibility for the asbestos removal as well as the considerable costs caused by this failure, project manager P will proceed to claim for Extension of Time and compensation for additional costs.

4.3 Implementation of the Decision

Task 5: Implementation of the decision.
After opting to claim against EP for financial and time compensation, project manager P has to decide which steps he must take to implement his decision. To this end he will consider the external relationship with EP and possible suppliers and subcontractors, as well as the internal processes to be observed within IPS.

4.3.1 External Implementation

First of all, P will check the contract for provisions related to the processing of cases of disruption watching out in particular for formal requirements since compensation claims may be excluded in cases of non-compliance with such rules. Having browsed the Contract and carefully read through sub-clauses 6.5 and 7.6 GC once again, he will decide to proceed in four steps:

- He must exchange views with EP's Construction Site Management (CSM) on the issue as soon as possible and try to get a clearer picture of EP's position, i.e. whether and to which extent it is willing to accept possible claims from IPS.
- Most importantly, IPS has to transmit a **notice of disruption** to EP with undue delay according to sub-clause 6.5, last paragraph GC. The notice shall describe in detail the hindering incident, why IPS considers it to be EP's responsibility and in which way and to which extent it affects IPS's work.
- As soon as he has a precise overview of the consequences of the disruption P has to list, estimate and document IPS's losses according to sub-clause 7.6, second paragraph GC as well as the additional time required as per 6.5 GC and to pass this information to EP.
- Finally, IPS will negotiate its compensation and extension of time claims and seek EP's acceptance.

P should further take precaution for possible claims from his subcontractors, which would place IPS in the position of the hindering purchaser. He also has to arrange for necessary time adjustments of the suppliers' and service providers' performances in accordance with the respective contracts.

4.3.2 Internal Implementation

Internally, IPS's disruption claims against EP will trigger two activities: The causes and the consequences of the incident must be documented in such a way that, in a worst-case scenario, evidence can be produced in court; further, the disruption claims and their negotiation need to be prepared and coordinated in line with IPS's policies and overall activities regarding EP. Since the preparation of a claim requires expert knowledge and involves a multitude of perspectives and processes, P will be supported by IPS's **Claims Management**.

Contract Knowledge: Claims Management
Claims management (or claim management) is an activity specific for project business. It designates a systematic approach to identify, process and enforce a company's own claims and to fight claims from the contractual partner during the entire project lifecycle. It must not be mistaken for accounts receivable management which addresses the tasks of invoicing and debts collection.

Claims management is executed as a function or by a specialized unit which supports the line management in cases of claims or handles such claims independently. It follows defined procedures and deploys specific tools, e.g. claims management software. Since claims management has, in the past, often been practiced in a rather aggressive way, many companies nowadays try to avoid the term but nevertheless practice claims management.

For **further reading** on claims management see [7], [8], [10]. For an **instructive case study** on claims management see [3].

Project manager P will give notice to Claims Management as soon as he becomes aware of the incident. Claims Management will support him in managing the external relationships as outlined under 4.3.1 but also the processes within IPS. It will create a case, describe the incident and assist P in securing evidence and documentation. If necessary, Legal (legal department) will be called in. With regard to the value at stake and the business relationship established with EP, P will also consult his superiors.

IPS's Claims Management will list the disruption claims in question along with other pending claims against EP (e.g. because of other disruption or change incidents) as well as EP's claims against IPS (e.g. because of delay). It will also coordinate consequential claims from or against subcontractors and suppliers. Finally, it will assist P in establishing the disruption claim against EP, negotiating it, monitoring the implementation of the respective agreement and tracking all further developments of the incident.

4.4 Actual Execution

For actual execution, see Sect. 4.7.

4.5 Challenge 2 (Modification 1)

4.5.1 Set of Facts

On March 6, IPS's project manager P and EP's Construction Site Management (CSM) discussed the situation caused by the detection of asbestos as outlined in the Initial Case. EP's CSM explained that the handling of asbestos had been excluded from IPS's scope of work because in the technical documentation of the original construction work of the boilers there were no indications for the deployment of asbestos in the area of the piping system. Considering the current developments, EP expressed its intent to source the respective work from IPS, since it was licensed for asbestos abatement work, had sufficient experience in this field and could work at a better price. It would be faster than other companies since it was already at the site and coordination would be much easier.

P objected that IPS was short of qualified manpower for asbestos abatement work and not in a position to perform as required. EP's CSM expressed its bewilderment at IPS's position and emphasized that, according to the Contract, it could order IPS to take on the respective work.

Project manager P considers whether IPS should perform the work and whether EP can order IPS to take on the task.

4.5.2 Operating Procedure

4.5.2.1 Author's Explanations

Modification 1 still relates to the **CM process step implement**. It once again stresses the contract's importance as a **management instrument** and highlights the limits of its binding effects in situations which require a modification of the project execution.

The main question at stake is whether IPS is obliged to comply with a possible change request from EP. Thus, P has to search for the relevant legal provisions and to find out whether they stipulate an obligation to comply with such a change order. The crucial management fields affected are **change management** and **knowledge management**, which provides the necessary information for making a solid decision. Modification 1 further shows that, in the CM process step draft, **risk management** will serve as the key for finding the appropriate balance between the need for a flexible contract that can cope with new developments and the maintenance of the equilibrium of performances originally agreed upon.

4.5.2.2 Reader's Tasks

Take the position of project manager P and process the following tasks:

Task 6: Find out whether the Contract assigns EP the power to unilaterally order a change of the Contractor's scope of work. (Level of difficulty: Medium)
Take 7: Make a decision whether IPS is obliged to execute the asbestos abatement work if so requested by EP. (Level of difficulty: High)
Task 8: Figure out a way to reconcile the expectations of EP and the interests of IPS. (Level of difficulty: Low)

4.6 Decision-Making Process

Task 6: Unilateral power to order changes.
A contract provides security that the obligations it stipulates or triggers are complied with by the respective party. In addition, it assures that nothing beyond such obligations must be performed. The binding effect of a contract as the parties' law is referred to as the Principle of ***Pacta Sunt Servanda***.

Contract Knowledge: The Principle of *Pacta Sunt Servanda*
It is a universally accepted principle of law that a contract is **binding** (*pacta sunt servanda*). Since it is one of the functions of a contract to establish security, the power of one of the contractual parties to unilaterally change the contract would be in contradiction to the very concept of the contract. Thus, as a rule, a contract can only be changed in the same way it has come into existence, which is through the consent of both parties.

As shown above, the asbestos abatement does not constitute a part of IPS's scope of work. However, project manager P is aware that, for projects, state law and, in particular, the contract may stipulate exceptions to the Principle of *Pacta Sunt Servanda* if an alteration of the project goals become necessary. Such setting is called **change** or variation.

Contract Knowledge: Change
Variation or change designates any alteration in the project goals regarding scope, schedule or other conditions. Since it leads to a "new" project, it does not trigger cost and time compensation but an adaptation of the contract including, in particular, a "new" price.

For **further reading** on change see [6], pp. 244–255.

Exceptions to the Principle of *Pacta Sunt Servanda* applicable in a situation of change may arise from contract law as well as from the contract.

Contract Knowledge: Duty to Cooperate and Change Order
The Principle of *Pacta Sunt Servanda* conflicts with the very nature of a project. Projects are unique ventures characterized by three features: complexity, long duration and a framework planning. Since it is practically impossible for the contractual parties, at the time of entering into the contract, to foresee in detail the project outcome and the way of its realization, changes are inevitable. In practice, projects are never implemented the way they have been planned and contracted.

Since the purchaser cannot achieve a positive project outcome without changes, he is in need of the contractor's cooperation if a change becomes necessary. The latter can abuse this situation and blackmail the purchaser by giving his consent only under the condition, for instance, of an excessive price. If he is interested only in short-term profit, he runs little risk since in the worst case he will just continue with the scope of work and the price of the original contract.

In order to provide a fair and effective legal framework for highly dynamic transactions, courts may interpret state law in a way which deviates from the Principle of *Pacta Sunt Servanda*. They can do so in two ways:

- They may acknowledge a duty of the contractual parties to negotiate changes that are necessary for the successful completion of the project in a collaborative manner and with the serious intent to finding a fair solution. Such duty to cooperate reduces the contractor's power to blackmail the purchaser by threatening not to change. In order to deal with this risk, contracts sometimes display clauses which explicitly state such **duty to cooperate**.
- Courts may also assume the power of the purchaser to unilaterally change a project regarding the contractor's scope of work or time schedule. Such action is called a **change order**. It must be distinguished from a **change request**, which is an upstream process step calling for an adjustment of a system.

The legal admissibility of a **change order** under state law is far from evident. In order to avoid the insecurities inherent to the judicial interpretation of state law, the parties may include a clause in the contract which explicitly grants the purchaser the power to order a change. Templates for project contracts will always provide such provision, which is legally valid, as long as it takes into due consideration the legitimate interests of the contractor. In this respect, the contract works as a management device since it provides for an efficient change management.

Sub-clause 8.1, first sentence GC stipulates the obligation of the Contractor to carry out such variations as the purchaser may require and thus grants EP the power to unilaterally order IPS to perform changes of its work.

Task 7: Decision whether to comply with the change request.
Even if IPS is entitled to order a variation, such power will not be unlimited but confined by contract or by state law in order to protect the contractor against its unfair deployment.

Contract Knowledge: Limitations of the Power to Order a Change
A contractual provision granting the purchaser the authority to unilaterally order changes is lawful only if it duly considers the legitimate interests of the contractor and protects him against abuse of power by the purchaser. Most frequently, limitations of the authority to order change are implemented through its exclusion in cases of lack of facilities, lack of capacities, unforeseeability of the work or a different nature of the work.

P will search the contract for limitations of the purchaser's power to order changes. Subclause 8.1 GC contains two such provisions. Its first paragraph confines change orders to variations in the originally agreed upon scope, design or manner of execution. Thus, the purchaser is allowed to change the work already attributed to the contractor but not to

order the performance of additional work which differs in substance from the work originally contracted. Further, sub-clause 8.1, second paragraph GC excludes the assignment of work that is of an extent or character the contractor could not reasonably have foreseen when entering into the contract. The two confinements, however, do not work at the same level; whereas the first paragraph deals with the issue of whether the changes relate to the contractor's scope of work, the second paragraph refers to the issue of whether the work, although related to the original scope, could reasonably have been foreseen.

Sub-clause 8.1, first paragraph GC reflects the generally accepted principle that change orders are lawful only if the requested variations do not cause work completely different from the tasks that the contractual parties originally agreed upon. Since asbestos abatement has a character entirely different from overhaul work, EP's request does not constitute a modification of the contracted scope of work but constitutes a new and additional task. The change order under consideration, therefore, is not lawful and the contractor can refuse to execute it. The asbestos removal work can be assigned to IPS only by means of an **additional order**, i.e. a bilateral agreement which amends the original Contract.

Task 8: A way out of the dilemma.
From a legal point of view, project manager P is free either to agree to the additional work or to refuse it. If he refuses, he must be aware of the possible negative implications his rejection may have on the business relationship as well as on the working relationship at the site. At the very least, he has to demonstrate a serious willingness to assist EP in efficiently solving the problem. Since it is obvious that EP doesn't want to coordinate the asbestos abatement work executed by another company, EP can do so by subcontracting the work fully or partially.

4.7 Actual Execution

In the case at issue, IPS transmitted a notice of disruption to EP on March 7. On March 12, the Estonian authorities issued an order to the Purchaser directing the asbestos abatement measures to be executed. After discussing the issue at the site meeting on March 21, P and EP's CSM informally agreed that IPS shall execute the asbestos abatement by using a subcontractor. IPS started the respective work the next day. On March 21, it specified its claims for disruption, demanding EUR 0.55 million as compensation and a time extension of 22 working days; for the asbestos work, it submitted an offer on the basis of a Cost-Plus-Fee Contract.

In the negotiations, for which EP was invited for March 30, IPS was represented by Projects (project department), Claims Management and Sales; for EP, CSM, Procurement (procurement department) and Legal participated. CSM scrutinized the evidence for the additional costs and expenses caused by the disruption presented by IPS, and both sides discussed the issue, in particular further possibilities to reduce the costs

and the loss of time by re-organizing the site work. Since resumption of production of the units could not be postponed, the parties agreed that IPS was to be paid EUR 0.9 million as compensation and for speeding up to the exclusion of any time extension. For the asbestos abatement, the parties agreed on a Cost-Plus-Fee Contract and EPS's fee to be EUR 65,000.

4.8 Learning Outcome

See Sect. 4.13.

4.9 Challenge 3 (Modification 2)

4.9.1 Set of Facts

After the challenges of the asbestos issues dealt with in the Initial Case and in Modification 1 have been overcome, IPS's work on the boiler pressure system for the Valma PP A1/A2 project is in progress. While preparing the activities on the ITS superheater of boiler A1 on May 4, IPS's project manager P realized that the overhaul work specified for this section in clause 45.6 Annex II of the Contract was inappropriate and a substantial replacement of the superheater was necessary instead. He provided information to EP according to sub-clause 8.2 GC, explained his findings and made propositions for rectification.

P now considers the next steps he will have to take depending on EP's reaction. He also wonders whether he may obtain a "good" price for the additional work and whether it will help to disguise and compensate delays in work since IPS's work package suffers from time and cost overrun due to various setbacks.

4.9.2 Operating Procedure

4.9.2.1 Author's Explanations

Modification 2 finds the project contract still in the **CM process step implement**. In the case of a variation, however, contract handling turns back to the **CM process step draft** in order to elaborate and agree on new conditions matching the modifications of the contractor's scope of work. In this process step, the parties are partially bound by legal rules again but also have leeway for negotiations. However, the bargaining power of the parties involved in a project is highly volatile and must be adequately addressed by **risk management** during the CM process step draft.

Modification 2 shows that the high complexity of projects calls for an advanced **knowledge management** system. Implementation and evaluation of changes require a

considerable amount of information to be fed into it by a multitude of departments and functions just as it has to provide relevant data for the respective management processes as required.

4.9.2.2 Reader's Tasks

Take the position of IPS's project manager P and process the following tasks:

Task 9: Make a decision whether to comply with EP's change request or not. (Level of difficulty: Low)
Task 10: Identify the external change procedure P has to observe in cases of a variation. (Level of difficulty: Medium)
Task 11: Assess the bargaining positions of EP and IPS regarding the conditions of the variation. (Level of difficulty: Medium)
Task 12: Consider which departments/functions P has to involve in the change process. (Level of difficulty: High)

4.10 Decision-Making Process

Task 9: Decision whether to comply with EP's change request.
P is aware that, regarding variations, two issues must be distinguished:

The first is whether EP's change request is lawful and thereby requires IPS to comply with it. As already discussed in Modification 1, Task 2, the purchaser can, according to sub-clause 8.1, first paragraph GC, unilaterally change the contracted work under the condition that the changes relate to the agreed upon scope, design or manner of execution and are of an extent or character which the contractor could reasonably have foreseen when entering into the contract. In contrast to Modification 1, both requirements are met in the case at hand: The new order relates to IPS's contracted work which includes the replacement of additional elements and support tubes, and the additional work was foreseeable because it is common in overhaul work that more replacements than expected turn out to be necessary.

The second issue relates to the consequences of a variation. In this regard, sub-clause 8.3 GC stipulates that, in the case of variations, the contract price, the time for completion and other terms of the contract shall be amended. Thus, although it is the purchaser who decides whether there will be a change, both parties have to agree how and under which conditions such change will take place. According to sub-clause 8.9, second paragraph GC, the contractor is neither allowed nor obliged to carry out the variation without prior agreement on such conditions.

Conclusion IPS has to comply with EP's change request after they have agreed on the conditions of the variation, in particular on the new price and the new time schedule.

4.11 Implementation of the Decision

4.11.1 External Implementation

Task 10: Change procedure according to the Contract.
IPS's project manager P knows that the change procedures he has to comply with are stipulated in the Contract. He is also aware that such formal requirements must be strictly observed, otherwise IPS may forfeit its right to payment or remuneration will be much more difficult to obtain.

The procedure for achieving consent on the consequences of the variation is laid out in sub-clauses 8.3 through 8.6 GC and forms part of EP's and IPS's project change management:

- According to sub-clause 8.4 GC, the purchaser shall give notice to the contractor that he requests a change (so-called **change request**) and shall explain in detail the work being requested and in which way it differs from the originally agreed upon scope of work.
- Sub-clause 8.5 GC requires the contractor to notify the purchaser whether he is able to carry out such variation, the manner he intends to execute it and the consequences for the price, the time schedule and other conditions of the contract. In legal terms, this is the **offer** to perform the change according to the conditions of the notice.
- The GC does not state the next step the parties have to take because it is evident: After being provided with all relevant information, the purchaser has to decide whether he wants the change to be carried out or not. If he agrees to the conditions of the contractor's notice as per sub-clause 8.5 GC, he legally **accepts** the contractor's offer. The written agreement on the conditions of the variation is called the **change order**. According to sub-clause 8.3 GC, it shall reasonably reflect the consequences of the variation and will be made part of the contract in the form of an **amendment**.

Contract Knowledge: Amendment
The parties' agreement on the conditions of the change alters the contract accordingly. The modified conditions of the contract will be stipulated in a separate document called **amendment**, which will be given a consecutive number and attached to the contract. Frequently, the contract will state that a change request form has to be used for a variation in order to ensure adherence to the process flow and proper documentation.

The additional costs for elaborating the offer will be included in the new price.

- In case the purchaser opts against the variation, the originally agreed upon scope of work remains in force and the contractor will be reimbursed the costs he incurred working on the purchaser's change request as per sub-clause 8.4 GC.

- If the parties cannot agree on the conditions of the variation, e.g. because of the contractor's price offer or the proposed time schedule, they have to proceed as stipulated in sub-clauses 8.8 through 8.12 GC and explained in part in Task 11.

Task 11: Bargaining power in variation situations.
After analyzing the change procedure as stated in the Contract, P will assess the opportunities to achieve a "good" price for the variation work and an extension of time which at least partially compensates the delays that have already occurred.

Consequently, he will give closer consideration to IPS's bargaining power. According to sub-clause 8.8 GC, EP may refer the dispute to be settled by an independent expert (the Expert) if he cannot agree with IPS on the consequences of the variation. Such procedure, however, is very time-consuming and even more so if one of the parties tries to postpone it. Yet, unless the parties have reached a written agreement or the matter has been settled by the Expert, the contractor is not obliged to carry out a variation as per sub-clause 8.9, second paragraph GC. Consequently, the purchaser bears the risk that a variation he deems necessary will not be carried out as soon as possible but only after the dispute has been settled. Meanwhile, the work will be continued on the basis of the old scope of work—which obviously no longer meets the needs of the purchaser—or it must be suspended at the purchaser's expense. If only the transaction is taken into consideration but not reputation and business relationship, the contractor bears no risk in such a scenario since he can continue work according to the original contract. Time is rather running against the purchaser: The longer the negotiations or the settlement take, the more pressure he will have to obtain, i.e. to "buy," the contractor's consent.

The purchaser, however, can protect against such handcuffing if he is aware of the risk and takes it into consideration when drafting the contract. He can do so by including an appropriate clause in the contract. It is likely that he will be successful with such a demand because in most cases, in the pre-award phase, the purchaser will have a stronger bargaining position than the contractor.

Contract Knowledge: Clauses Reducing the Contractor's Bargaining Power in Change Situations
To avoid being blackmailed in change situations, the contractor has to take appropriate precautions during the CM process step draft. Based on his contract risk management, he has to assess this aspect of change risk and, if necessary, mitigate it through provisions which reduce the contractor's capabilities for excessive claims. Two types of clauses can be used to this end:

(a) "The Contractor shall commence the execution of the variation requested by the Purchaser even if the parties have not yet agreed on the conditions of such variation. Until such agreement has been achieved, the Purchaser shall reimburse the Contractor's costs and expenses."

Such clause weakens the bargaining position of the contractor because he has to start the modified work immediately upon reception of the purchaser's change order. It relieves the purchaser's time pressure since work on the requested change has already begun and he can take his time to negotiate. In contrast, the contractor finds himself in an unfavorable bargaining position since he has to fight for his profit.

(b) "The Contractor shall submit his price in the form of a price breakdown per unit as defined in Annex III of this Contract. Price adjustments in case of a change request shall be mutually agreed upon by the partners on the basis of such prices per unit and shall reasonably reflect the consequences of the variation."
The clause restricts the contractor's bargaining power regarding the price because he is prevented from renegotiating the full contract price. He can only claim for the adaptation of the part of the contract price which relates to the respective unit and only in accordance with its original price basis.

However, it should be stressed that the issues related to changes largely depend on the contract type. In the case at hand, the parties agreed on a Fixed-Price Contract which is quite change resistant. If changes of a considerable extent are expected and the final costs cannot be predicted with accuracy, a different contract type may be preferable, in particular a reimbursable contract, e.g. a Cost-Plus-Fee Contract. Thus, the **choice of the contract type** during the CM process step plan is an important means to reduce change risk.

After scanning the Contract again, P is assured that it does not include any such clauses. Thus, in the upcoming negotiations, EP will have a weak bargaining position and will largely depend on IPS's corporate culture, the attitude of its decision-makers, its state of affairs and the customs of the sector. All in all, IPS will be in a very comfortable position to obtain a "good" price and time schedule for the variation.

4.11.2 Internal Implementation

Task 12: Departments/functions to be involved.
Figure 4.1 displays IPS's management functions being affected by the variation at issue as well as the respective information and communication processes. It should be noted, however, that the internal organization of enterprises and process flows may show considerable differences.

The following numbers refer to the arrows in Fig. 4.1. They rearrange the information and communication processes within IPS according to incoming (IN) and outgoing (OUT) information and show the management functions involved.

1. EP's **change request** as per sub-clause 8.4 GC will be forwarded to Projects which will call in Claims Management (CLM).
2. Projects and CLM will make a decision whether to change, i.e. whether EP's request qualifies as a change request and IPS is in a position to perform the requested work. If necessary, they will call in Legal.
3. Projects will provide corresponding information to Sales and Risk Management (RM).
4. Next, Projects and CLM with the support of RM and Sales will elaborate the **conditions of the change** to prepare the notice according to sub-clause 8.5 GC. Legal will be involved if the change is of significant importance and raises contractual issues. RM will evaluate the consequences of the intended change. Corporate management may intervene if strategic interests of the company are at stake.
5. Relevant data on the outcome will go to Projects, CLM and Finance.
6. Projects and CLM will negotiate the amendment with EP's representatives.
7. If the parties have agreed on the **amendment**, its conditions will be communicated to Projects, CLM, RM and Accounting.

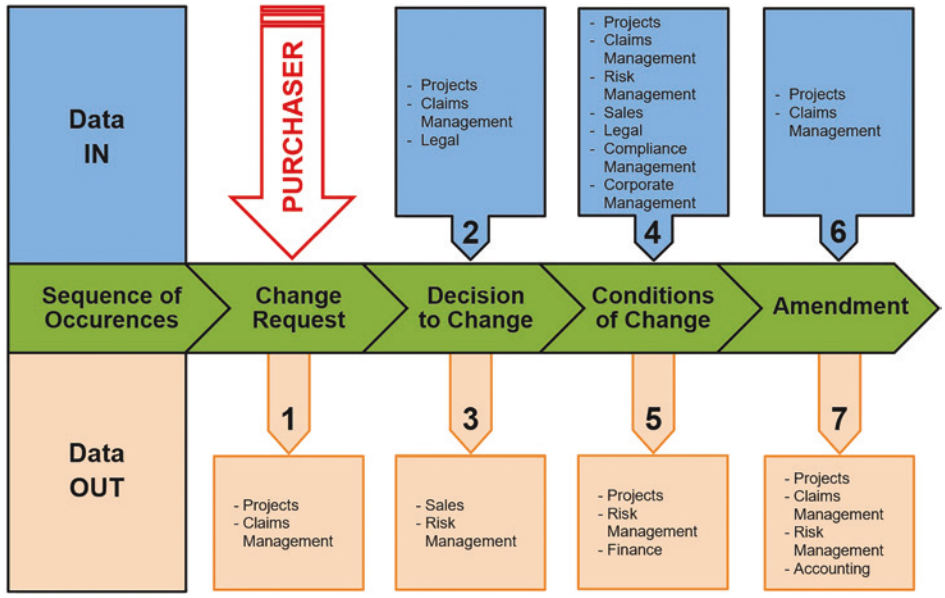

Fig. 4.1 Processing of a change request

4.12 Actual Execution

After having received EP's change request on April 17, IPS has sent a note as per subclause 8.5 GC specifying the proposed overhaul work for the ITS superheaters for the boilers A1 and A2. The following day, IPS was invited by EP to explain its propositions in a meeting scheduled for May 9.

At the meeting, IPS was represented by Projects and Sales, EP by CSM and Procurement. The parties discussed the changes proposed by IPS as well as their technical and organizational effects on the related work. IPS requested a price increase of EUR 225,000 per boiler and a time extension of 7 working days. Both sides discussed the issue in detail and finally agreed on a price of EUR 210,000 per boiler and the persistence of the Contract's deadlines.

IPS started with the implementation of the modified work the same day, and received EP's written change order two days after the meeting.

4.13 Learning Outcome

4.13.1 CM Value for the Case Study

The Tricky Boiler case demonstrates how the Contractual Management Model (CMM) allows for the systematic approach to a decision situation in which challenges during project execution must be dealt with. It highlights the fact that the range of decision options as well as their effectiveness depend largely on the quality of the contract planning and drafting activities which in turn are shaped by a company's risk management and knowledge management systems. Thus, the project contract serves as an **instrument to manage** unforeseen events in project execution.

The management of foreseeable but unplanned events, thus of **risk management**, takes place during the entire contractual management cycle, either proactively or reactively. It starts with the CM process step plan, because, for instance, a reimbursable contract can respond much better to the variation risk and is much easier to change than a fixed price contract; it continues with the inclusion of clauses reducing the bargaining power of the contractor in situations of variation, disruption or an additional order in the CM process step draft; and—after passing further process steps—it ends with the CM process step evaluate, ensuring that the sample contracts, risk checklists etc. are reflecting best practice in general and specific experiences of the enterprise in particular.

The model further highlights the **need for an effective and structured communication** before and after a decision is made. A manager cannot appropriately handle an unplanned event in project execution unless he has at hand all relevant information regarding the legal and factual conditions. The integrative approach of the model will

direct him to the relevant departments or functions of the enterprise which provide such data or vice versa are in need of information input.

The CMM also highlights that a project contract in the first instance is **drafted for the project manager** and not for the judge. It covers a multitude of organizational issues and defines the processes which provide the framework for project execution. For this reason, the contract can be considered the roadmap of a project, which implies that a project cannot be managed successfully without the project manager having the contract at hand as well as reading, understanding, and applying its provisions.

4.13.2 Case Study Value for the Reader

The reader learns about important contractual instruments to handle deviations from the project plan after the contract has been signed and transferred into the execution phase. He is introduced to the legal concepts of disruption, variation, Force Majeure and additional order as well as their conditions of application and the legal, business and social consequences they may have. He further becomes familiar with terms and instruments crucial for the understanding of project business such as scope of work, change request, amendment or claims management.

The reader will understand the business, social and organizational dimensions of the contract in general and of contract provisions addressing project disruptions in particular. He sees how such contract provisions are created, deal with risks and relate to the respective provisions of state law. He becomes aware of the crucial role information plays for decision-making with regard to project disruptions as well as which departments or functions of the enterprise will provide or have to be supplied with such information. Finally, he observes that the contract is only one source of motives bringing about a decision in business and that it will not be applied in an immutable way according to its letters but flexibly according to its environment of deployment and the personal, business and further stakeholder interests involved.

The reader acquires the ability to analyze the nature of unplanned developments in project execution and to relate them to the relevant concepts of project management as well as to the corresponding contractual provisions. He is able to evaluate the effects of such concepts and provisions according to the given situation and, in particular, to identify the advantages and disadvantages they may produce for the parties involved. He learns to choose the appropriate legal instrument to deal with the detrimental impact on the project execution and to implement it internally and externally in a meaningful manner. All in all, he will be capable of systematically approaching and effectively managing disruption and variation situations.

Appendices

Extracts from the Contract Overhaul Valma Power Plant A1/A2

AGREEMENT
Article 3
The contractor shall perform the works specified as per Appendix II of the contract.

APPENDIX II
62 The following works are not part of the contractor's scope of work. They belong to the obligations of the purchaser to be realized properly and free of charge for us.

…

62.9 Dismantling of asbestos and asbestos-contaminated materials, storage in suitable containers, transport and disposal.

GENERAL CONDITIONS (excerpts)
(Reprint of **ORGALIME Turnkey Contract for Industrial Works—General Conditions** with friendly permission of ORGALIME, BluePoint Brussels, Boulevard Auguste Reyers 80, 1030 Brussels).

4.2 Contractor's Obligations. Scope of the Contract
The Works shall have the scope set out in the Contract. The Works shall include all that is necessary for the Works to fulfil the operating characteristics and performance requirements specified in the Contract, provided that the Purchaser has supplied equipment, supplies and services in accordance with his contractual obligations.

6. Representatives, Coordination, Extension of Time
6.5 Contractor's Right to Extension of Time
The Contractor shall be entitled to a reasonable extension of the Time for Completion if he is delayed by:

(a) failure by the Purchaser to perform correctly and in time any of his obligations under the Contract, regardless of the reason for such failure,
(b) actions or omissions by any contractor or person employed by the Purchaser,
(c) any physical conditions (other than climatic conditions) or artificial obstructions that the Contractor encounters on the Site, which could not reasonably have been foreseen by an experienced contractor on the basis of data provided by the Purchaser or otherwise readily available or from a visual inspection of the Site,
(d) a variation in accordance with Clause 8,
(e) suspension by the Contractor under Sub-clause 9.4,
(f) suspension by the Purchaser under Clause 10,
(g) any damage caused by the Purchaser's Risks, or
(h) any circumstance which constitutes Force Majeure.

In order to avail himself of his right to an extension of time, the Contractor must, however, notify the Purchaser without undue delay after at the time when the Contractor becomes aware of, or should have realised the need for an extension. The notice shall state the reason for the extension and, if possible, the length of the extension.

7. Work on the Site
7.6 Contractor's Additional Cost and Expense
The Contractor shall be entitled to compensation by the Purchaser as hereinafter specified for additional cost and expense, which the Contractor reasonably incurs due to any of the circumstances referred to in Sub-clause 6.5, first paragraph (a) through (h).

In cases referred to in (a) through (c) the compensation shall cover:

- waiting time and time for extra journeys,
- additional work, including work to remove, secure and set up erection equipment,
- costs incurred by the Contractor in having to keep his equipment on the Site longer than foreseen,
- additional costs for travel, board and lodging for the Contractor's personnel, and
- other costs which the Contractor can show he has incurred due to the changed circumstances of the work.

The compensation for variations (d) shall be as specified in Clause 8.

8. Variations
8.1. Contractor's Duty to Carry Out Variations
The Contractor shall until taking over of the Works be obliged to carry out such variations as the Purchaser requires in the agreed scope, design or manner of execution of the Works.

The Contractor shall not, however, be obliged to carry out a variation required by the Purchaser as referred to in the first paragraph of this Sub-clause, where such variation is of an extent or character which the Contractor could not reasonably have foreseen when entering into the Contract.

The Contractor shall further carry out variations which become necessary due to changes in Laws and Regulations which apply to the Works and in the generally accepted interpretation or application thereof. This obligation shall apply in respect of all amendments which come into effect after the Main Contract Document was signed and before the date of taking over of the Works.

8.2. Variations Suggested by the Contractor
The Contractor shall inform the Purchaser of possible variations, which the Contractor considers to be in the interest of the Purchaser. The Contractor shall further inform the Purchaser of any changes occurring in standards and norms, which, according to the Contract, shall be observed in the performance of the Works.

8.3. Amendments of Terms of the Contract
In case of variations, the Contract Price, the Time for Completion and other terms of the Contract shall be amended to reasonably reflect the consequences of the variation.

8.4. Purchaser's Request for a Variation
The Purchaser shall give notice to the Contractor of his request for a variation under Sub-clause 8.1. The notice shall contain a detailed description of the variation.

8.5. Notice regarding Terms for a Variation
The Contractor shall, without undue delay after he has received the Purchaser's request referred to in Sub-clause 8.4, notify the Purchaser whether it is possible to carry out the variation and, if so, specify the manner of execution and the effects of the variation on the Contract Price, the Main Time Schedule and other terms of the Contract.

The Contractor shall also give notice as referred to in the first paragraph when he becomes aware of the need for a variation under Sub-clause 8.1, third paragraph.

8.6. Contractor's Costs for Examining a Variation
The Purchaser shall reimburse any costs incurred by the Contractor in examining the consequences of a variation requested by the Purchaser.

8.7. Disputed Variation
If the parties disagree on whether certain work, which the Purchaser requires to be performed, is already included in the Contractor's obligations under the Contract, then the Purchaser shall give notice to the Contractor specifying the work he requires to be performed and stating why he considers the work to be included in the Contractor's obligations. This shall also apply if the Contractor has refused to carry out a variation with reference to Sub-clause 8.1, second paragraph, and the Purchaser maintains that the variation shall be carried out.

The Contractor shall, without undue delay after receipt of the Purchaser's notice under the first paragraph of this Sub-clause, give a notice as referred to in Sub-clause 8.5, and therein specify why he considers the work to fall outside his obligations.

8.8. Referral to Independent Expert
If, after the Contractor's notice under Sub-clause 8.5 or Sub-clause 8.7, second paragraph, the parties fail to agree on the variation or on the resulting amendments of the terms and conditions of the Contract, the Purchaser may, by notice to the Contractor, refer the dispute to be settled by an independent expert (hereinafter "the Expert"). The Purchaser shall in his notice specify the questions to be decided by the Expert.

8.9. Contractor's Duty to Carry Out Requested Variation/Work
If, in the case of a dispute regarding a variation referred to in Subclause 8.1, third paragraph, the Purchaser fails to refer the dispute to the Expert within 28 days after he

received the Contractor's notice under Sub-clause 8.5, the Contractor shall carry out the variation in accordance with the terms and conditions specified in his notice.

Except as specified in the first paragraph of this Sub-clause 8.9, the Contractor shall not be obliged or entitled to carry out a variation or disputed variation before the parties have reached a written agreement on how it shall be carried out and its consequences, or the matter has been settled by the Expert.

24. Force majeure

24.1. Force Majeure

The following circumstances shall constitute Force Majeure if they impede the performance of the Contract or makes performance unreasonably onerous: industrial disputes and any other circumstance beyond the control of the parties such as fire, earthquake, landslide, storm, flood and other natural disasters, war, mobilisation or military call up of a comparable scope, requisition, seizure, currency and trade restrictions, insurrection and civil commotion, shortage of transport, general shortage of materials, restrictions in the use of power and defects or delays by subcontractors caused by such circumstances.

The above described circumstances shall constitute Force Majeure only if their effect on the performance of the Contract could not be foreseen when the Contract was entered into.

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5 The Click and Wrap Case—Relevance of the Contract for the Adoption of Cloud-Based CRM Applications

Sarfaraz Ghulam Muhammad, Vladimir Stantchev and Daniel Arias Aranda

Contents

S. G. Muhammad (✉)
SRH IT Solutions, Berlin, Germany
e-mail: Sarfaraz.GhulamMuhammad@srh.de

V. Stantchev
SRH Hochschule Berlin, Berlin, Germany
e-mail: vladimir.stantchev@srh.de

D. Arias Aranda
Universidad de Granada, Granada, Spain
e-mail: darias@ugr.es

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Abstract

This case study addresses online contracts associated with providing software as Software-as-a-Service (SaaS)—a provision model of cloud computing. It investigates a company planning to migrate from an on-premise scenario to using SaaS services for its CRM system. The SaaS services can only be accessed by clicking the service agreement with no opportunity to negotiate the contract. The manager in charge of the CRM migration project faces interrelated issues in different fields such as project management, contracting, customer relationship management, data migration etc., all related to various contractual relationships. Guided by the CM Approach and CM Model, he develops a roadmap for the adoption of the CRM system, starting with the identification of the issues to be addressed, continuing with propositions for the choice of the new system and with a request for the modification of the company's governance model, and finally ending with the successful data migration. To this end, it highlights the value of risk management for the identification of relevant decision-making fields and the many ways in which change management leads to questions related to contracts as well as contract handling. The case study also considers the governance policies of an organization and underlying complexities when it comes to choosing a cloud-based service, applications which use cloud-based technology or are offered online, as well as certain services which could go against such governance policies.

Keywords	Cloud computing, contract automation, digital contract, click and wrap contract, smart contract, Service Level Agreement
Principle management topic	Enterprise networks
Institution	Small-sized company, private, profit
Subject of management	Transaction, enterprise
CM process step	Plan, implement, monitor
Management field	Change management, risk management
Contract type	Service contract, SaaS contract

Editor's Note: For a full understanding of the CM Model's practical benefit for the case study, the reader may have to peruse at least sect. 1.4.4 and 1.4.5 of Part I. The keywords used above to characterize the area of contract application are explained in the key system preceding the case studies in Part II.

5.1 Challenge

5.1.1 Set of Facts

Paper Cubs, henceforth PC, is a Berlin-based company operating since 1998 as a well-known IT, data research and consultancy firm. PC conducts research on specific consumer electronics for the German and European markets. The company collects data for its customers, processes the collected data and provides market updates about products, customer behavior and customer preference. The reports generated by PC help its customers to develop better business strategies and counter its rivals' strategies in an increasingly competitive market. The service contracts that PC offers have a duration of 5 years. After expiry, the customers are expected to renew the service terms according to the then applicable conditions. Although big companies can conduct research by themselves, outsourcing such tasks is in many cases more appropriate because it allows them to save time and focus on their core competencies of product development rather than market research. Smaller companies normally don't have the resources to undertake such endeavors.

Since the company's foundation, PC's IT department has had to meet similar tasks and requirements, such as maintaining an active and fully functional database, organizing the client systems, server and file management, active file sharing, developing and programming software, collecting and processing customer data and data for the customers as well as serving the company's other IT needs as required.

PC currently uses an on-premise private cloud infrastructure to run its **Customer Relationship Management system** that it also provides to its customers.

Explanation: Customer Relationship Management System
A Customer Relationship Management system (CRM system) is a support system which helps an organization to manage its customer data. It employs data analysis technique for customer history and analysis of information from and relating to customers in order to enable better decision-making. With the primary objective of improving company sales, CRM systems have been widely used in organizations around the globe since their successful introduction in the early 1990s.

For **further reading** on CRM systems in general, see [1], pp. 251–261 and on the world's leading CRM cloud solution, Salesforce, see [2].

PC provides its customers with Software-as-a-Service (SaaS) applications running on their platform, and all data collected and generated by PC are processed and kept in their in-house database only. According to PC, this makes them highly trustworthy in the market and constitutes a competitive advantage over their rivals. Consequently, they give assurance to their customers each time they sell a product that all customer data is processed in PC's private cloud infrastructure using the software produced in-house and that customer data cannot be accessed by any third-party. However, infrastructure and maintenance costs for the CRM system are high.

Furthermore, PC puts particular emphasis on its customer contracts. They consider signed contracts as a means to ensure trust and integrity between the partners, even more so since, in Germany, contracts are given special importance, and most of PC's customers still rely on signed documents and hard copy contracts. However, with the advent of cloud based digital services, their customer's mentality in this respect is undergoing considerable changes.

Strict in-house data processing and a policy of avoiding contract automation has been adopted as part of PC's business strategy and governance policy and embodied inter alia in their IT and IT-security guidelines. PC believes that doing so makes their offering and brand trustworthy to their customers, showing that they take contracts and data privacy seriously and that individual treatment of customers is a high priority for them.

A cost and benefit analysis undertaken in 2018 displayed that in-house software solutions are not feasible in the long run because of the considerable costs involved and the challenge of keeping up with state-of-the-art developments. Off-the-shelf systems available on the market are more advanced and efficient than PC's own solutions and provide better results and a superior user experience. Therefore, PC's Board of Directors decided to take steps to revamp its IT services and organization. This involved recruiting new IT team members who are knowledgeable and skilled in up-to-date online technologies and in outsourcing IT-related tasks. After careful assessment and interviews conducted with several candidates, PC hired John Douglas as their new Chief Technology Officer (CTO).

Furthermore, the Board of Directors felt the need to update the current CRM system to be up to the modern standards and as efficient as the systems their competitors are using. The new system should support PC's customers for the foreseeable future along with a comprehensive service package available 24/7. At the same time, the Board of Directors stressed the importance of information security and data integrity. Following intense discussions, it decided to go for a third-party provision of the CRM services. John was given a special assignment to make a proposal for the new CRM system and retire the old one. If possible, switching to the new system should be done with the consent of their customers and a vendor lock-in of customers should be avoided.

The project team organized for the planned change of the CRM identified the following key features of the package to be discussed with the prospective service provider:

- During the active period of PC's contract with the third-party service provider, the latter will be responsible for the support, update and optimization of services as well as any related demands occurring during the life span of PC's service contracts that are between 1 and 5 years old. All data processing will be the assignment of the service provider, whether they were data from PC or PC's customers.

- The CRM system must be highly flexible regarding service capacities as well as the types of services PC's customers require. Adaptation of the services need to be realized swiftly and with a high resource efficiency.
- It is highly desirable that contracts are concluded and managed by humans and not by machines. This refers to the service contracts agreed upon by PC and the prospective service provider as well as to the contracts concluded between PC and their customers.

The challenge that lies ahead for John is complex and involves in particular the following tasks:

- Choosing a reliable and trusted service provider;
- Replacing the old internal CRM system with a new and external system;
- Introducing necessary changes in the corporate governance policies;
- Implementing the changes with a minimum of internal and external frictions.

Many of the related decisions are based on or related to contracts.

5.1.2 Operating Procedure

5.1.2.1 Author's Explanations

Contracts are instruments of great importance for companies, and their handling requires specific knowledge and skills. This is why companies need advanced expertise in contracting if decisions crucial for their success are substantially influenced by contracts. For PC, as an SME without an in-house lawyer, establishing a novel standard for contract handling is not a simple task and can easily fail because self-made standards often lack some important aspect or overestimate specific topic areas depending on the knowledge and experience of the employee preparing such standards.

Therefore, PC would be well advised to **rely on an existing model** when they devise the standard operating procedure for the adoption of the new CRM system. The Contractual Management (CM) Model can help them in meeting high standards with regard to managing their contracts and managing through contracts. It provides a road map for contract usage and shows the manager how to make better decisions related to contracts. Furthermore, John can use it as a guide to identify the main challenges contracting is generating in a specific field.

Organizations can tailor the CM Model to their specific needs and hereby deploy it fully or partially by choosing the relevant parts and omitting the ones of less importance. Figure 5.1 shows a version of the CM Model made suitable for the purposes of PC.

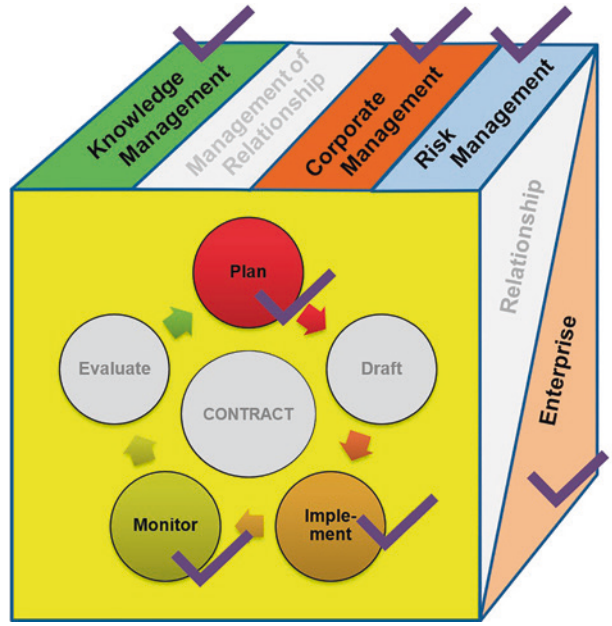

Fig. 5.1 The CM Model displaying aspects of application (Based on Schuhmann and Eichhorn, Chap. 1 of this book)

The front side of the cube displayed in Fig. 5.1 depicts the CM cycle and marks those process steps which are of specific relevance for our case. Since PC is largely in the planning phase for its CRM system, John will focus on the CM process step plan as well. Due to the largely standardized and automated character of the applications, his planning decisions will reach far into the contents of the contract, pushing contract drafting further into the background. As John's proposal will clearly aim at contract automation and **smart contracts**, the planning outcome will further predetermine the way in which the contract is implemented and monitored. However, since both aspects are important features of the new CRM system, they merit closer consideration.

Contract Knowledge: Smart Contracts

Smart contracts emerged with the advent of web services and should not to be confused with legal contracts. Both concepts have in common that they depict a transaction, but whereas a smart contract is a software code that autonomously executes certain transactional activities without human interference, a legal contract addresses a human being for its execution—in most cases both contract partners separately for specific activities—or has to be transferred into a software code. However, a smart contract can become a legal contract if it meets certain requirements. These requirements are still under discussion and vary from jurisdiction to jurisdiction.

The technical foundations of smart contracts are approaches for rich definition of program interfaces. These definitions are specified in a formal way and include details about how the interface should be called including preconditions and

postconditions. An interface is comparable to a steering wheel interacting with the steering of a car—it is the only and well-defined way to do it. Across such interfaces, different software applications can communicate and thus perform specified functions.

A special and certainly the currently best-known case of a smart contract is the one implemented on blockchain technology (e.g. Ethereum) which autonomously executes the performances of the transaction—the service provision and payment. The concept of smart contracts is thus closely connected to that of contract automation explained below.

For **further reading** on smart contracts, see [3, 4].

The right side of the cubical model refers to the **subjects of management**: "relationship," which here refers to PC's transactions with the service provider and with its customers, and "enterprise." The latter makes the user of the CM Model aware that the new CRM system and thus the contracting model will tremendously affect PC's business model, governance policy and the relationships with its customers.

The top of the cube highlights the management fields that need to be considered for all contract-related decision-making.

- Most obviously, the case at hand relates to the **management of relationship** because the new CRM system and its embedded contracting procedures will significantly impact the appearance and the working of the contracts that PC concludes with the service provider as well as with its customers and hereby shape the corresponding relationships. However, since this impact is only a reflection of the strategic decisions John has to make, management of relationship shall not be considered here.
- **Risk management** can help PC to identify the issues which need closer consideration and ultimately require a decision, just as it delivers the parameters for decision-making. A systematic deployment of the risk management approach will bring to light all relevant topics associated with the intended CRM system overhaul. For instance: To which extent do we have control over the services and what will be the consequences for us? How much negotiation leeway do we have concerning the conditions of the service contract, and what risk are we running if we must accept pre-defined terms and conditions? What is the risk that the software update alienates loyal customers, how many of them may we lose, and what are the benefits compared to this risk? By understanding the risks, PC will be able to make an informed decision. For instance, if the risk is temporary but the benefits are long-term, they may choose an option despite the possible negative impact on its interests in the nearer future.
- **Corporate management** will provide John with the normative framework of rules, policies and processes concerning PC's dealing with customers and partners as well as the set of internal processes his decision-making must take into account in

particular if it requires approval. In turn, this aspect of the CM Model will make him aware that his propositions for the new CRM system go beyond the single transaction with the service provider but rather are of strategic importance and relevance for the future market performance of PC.

- The reader of the case study is invited to pay specific attention to **knowledge management**, the fourth management field of Contractual Management, beyond its obvious relevance for a data research and IT consulting firm. He or she should in particular consider how digitization and automatization of contracts affect their design, conclusion, execution, monitoring and analytics as well as communication processes and patterns of human interaction.

  Because knowledge management works as a cross-sector process for Contractual Management, it can also help to identify the various communication lines along which information required for contract handling is retrieved from the other management fields (input) and, in turn, information produced through contract handling is fed back into the processes in these management fields (output):
  - **Management of relationship**
    Input: Technical requirements for the CRM system; requests for changes in service; KPIs for contract performance; etc.;
    Output: Valid contract; reporting; contract amendments and extension; etc.
  - **Corporate management**
    Input: Policies and strategic decisions with regard to third-party service provision and the use of automated contracts;
    Output: Approval requests; proposals for the change of corporate policies.
  - **Risk management**
    Input: Risks associated with the new CRM system as far as it relates to cloud computing, off-the-shelf applications and contract automation;
    Output: Measures to mitigate the risk of loss of customers; red lines for the terms and conditions that can be accepted; exclusion of specific products or providers; etc.
  - **Knowledge management**
    Input: Knowledge in change management, project management, and data migration;
    Output: Data about customer's preferences; experience in data migration; experience in addressing customers in situations of service changes.

Hence, John should use the CM Model as a road map for identifying and addressing the relevant aspects he has to consider when making up his mind on the features of the new CRM system and dealing with related challenges.

5.1.2.2 Reader's Tasks

Take the position of John and process the following tasks:

Task 1: Identify the requirements that the CRM system must meet as well as the options at hand. (Level of difficulty: Medium)

Task 2: Make a proposition for PC's new CRM system. (Level of difficulty: High)
Task 3: Explore PC's chances of being offered customized service packages and the effects this will have on their business model. (Level of difficulty: Medium)
Task 4: Identify the options that the service contract offers PC to cope with changing demands. (Level of difficulty: Medium)
Task 5: Find out how the new CRM system allows PC to monitor services. (Level of difficulty: Low)
Task 6: Elaborate on the possibilities PC's customers have to monitor their service modifications and to keep track of important deadlines. (Level of difficulty: Low)
Task 7: Make propositions to adjust PC's customer relationships to the new CRM system. (Level of difficulty: High)
Task 8: Make suggestions for a smooth adaptation of the new CRM system with specific emphasis on the migration process. (Level of difficulty: High)

5.2 Decision-Making Process

5.2.1 Identification of the Decisions to be Made and Evaluation of Decision-Making Circumstances

Task 1: Identify the requirements that the CRM system must meet as well as the options at hand.
Starting with the decisions of the Board of Directors as well as the needs of PC, John will find that the proposal he has to submit must meet the following requirements. The new CRM system must be

- state-of-the-art,
- cost-efficient,
- supporting PC's business model and
- complying with PC's governance policies.

Since PC has its own system and policies to process customer data, it was mostly able to address IT governance issues in-house. But with the expansion of their system and the increasing pressure for cost-effective and cutting-edge technology, there is a growing necessity to outsource these services to a **third-party provider**. Apart from other advantages, this will allow PC to gain access to state-of-the-art technologies available on the market which their competitors are already using. On the other hand, in-house maintenance and processing of customer data features as a crucial point of PC's business model and is therefore laid down in their corporate governance policy.

Nowadays, a good majority of companies prefer to use **off-the-shelf** CRM systems that come with ready-made solutions and functionalities which meet the market requirements. PC was using their own software solutions but meanwhile they have realized that

going to off-the-shelf would be more favourable for them, in particular in terms of cutting costs of the manpower they deploy for the old system and for getting access to better and more cost-effective solutions. Furthermore, they could reduce PC's dependency on its decaying CRM system and the resulting vulnerability.

In this context, John has to consider **PC's contract policy** as another key factor in his decision. So far, PC's business model emphasizes individual contact with each of their customers backed by contracts that are closed, modified, terminated etc. manually, based on individual treatment and hard copies. Off-the-shelf solutions provided as SaaS, however, are working to a large extent through **automated contracts** and insofar either fully or partially exclude human interaction in contract handling and hereby an individual response to the customer's requests.

Contract Knowledge: Automated Contracts

Automated contracts are contracts consisting of the genuine contract and instead of being monitored manually by humans are programmed together with the application. Upon application or program installation for the first time, users are presented with the contract. The programmed part of the contract is responsible for keeping records of important dates such as its validation and other aspects like the functions available to the users, and assist and adapt with modifications. The overall benefit of the online contract is that it doesn't need human interaction or follow ups and is capable of operating and managing autonomously on behalf of the service provider and the service customer.

For **further reading** on automated contracts, see [5–7].

Click and wrap contracts as a form of automation, thus, would not be in line with PC's current governance policy (For click and wrap contracts see Sect. 5.3.1.1).

The most advanced and convenient third-party off-the-shelf CRM services nowadays are provided as SaaS and thus as cloud solutions ([8], [9] and10]). Most traditional vendors of CRM systems such as Microsoft and SAP have developed SaaS versions of their products. Pure SaaS players such as Salesforce have gained a large share of the market. However, SaaS has a differing environment for IT Governance [11], especially with respect to data privacy. The choice of a SaaS solution, therefore, has its own downside since PC places great importance on data privacy with regard to customer data. John will have to consider in particular that the cloud services industry is dominated by USA origin service providers which face considerable distrust in many European states regarding the assurance of data privacy according to European standards.

Explanation: Data Privacy in US Based Clouds

If personal data of a data subject in the European Union (EU) are to be transferred to third countries or such activities are undertaken by organizations in the EU,

the requirements of Art. 44 et seq. GDRP (General Data Protection Regulation, Regulation (EU) 2016/679) must be met [12]. In particular, personal data are allowed to be transferred outside the European Economic Area only if the receiving country provides an "adequate level of protection." In the past, this issue has been a constant source of discussion and uncertainty of the market. According to an informal accord reached between the EU and the US government, an "adequate level of protection" is assumed if the US based service provider is certified under the Privacy Shield or deploys EU standard terms and conditions.

In March 2018, the so-called CLOUD Act (short for Clarifying Lawful Overseas Use of Data Act) entered into force upon signature of the President of the United States. The act stipulates that the US IT service providers and internet companies upon request of US authorities are obliged to hand over data even if stored outside the US, for example on a server located in a member state of the European Union. The act's purpose was to counter the defeat in the New York Search Warrant Case from 2013 (*United States vs. Microsoft Corporation*) which declared Microsoft's refusal to handing over of data to US authorities to be lawful. Hence, there are reasonable risks that US law enforcement may have wide access to data stored and processed by US companies or their subsidiaries on servers located in the EU. Meanwhile, most international cloud vendors provide services where they assure that all customer data are stored and processed only within Germany or within the EU. There are various standards that are applied to manage information security, see [13].

For **further reading**, see [14]; on the Microsoft Case and the CLOUD Act, see [15].

In consequence, John will consider proposing a service provider that does not transfer data outside the EU. Because of the CLOUD Act, he may further have to exclude US-based providers and their subsidiaries even if based within the EU in order to fully dissipate their customer's data privacy and data security concerns. Given the dominance of the US service providers, this would considerably reduce the options at hand. However, trust models such as Microsoft's "Office 365 Deutschland" may be an option.

5.2.2 Preparation of the Decision

Task 2: Make a proposition for PC's new CRM system.
Choosing CRM applications of a third-party service provider or cloud-based processing of the data is a nontrivial task [16, 17]. John will have to make a careful analysis of the pros and cons before he will be able to submit his proposition. Using the risk management lens will help him to identify all issues that need consideration and to mitigate and monitor the relevant risks in a systematic way.

5.2.2.1 Risks and Opportunities of the Different Options

PC's Board of Directors has already expressed its consent to the **outsourcing of the service provision**. In light of PC's size and considering the effort for maintaining and developing its own CRM applications on an on-premise private cloud infrastructure, there is no viable alternative to third-party service provision.

However, John and the project team will have to think about a strategy to cope with the downsides of the decision to outsource. PC must face the fact that it will have limited control over the quality and reliability of the services delivered to their customers by the third-party provider. Any major malfunction, data breach or other incident happening in the data center of the service provider will directly affect their service relationship with their customers without having the possibility to directly intervene. Furthermore, the software and the related solutions coming from the third-party service provider will leave less room for PC as well as for their customers to mitigate privacy risks directly. These downsides bear the risk that loyal customers may be alienated from PC or even withdraw from its services. It can only be mitigated through a sensible customer migration comprising information, individual advice and, if necessary, material incentives. However, the residual risk of losing loyal customers is likely to be offset by attracting new customer groups.

Choosing a **cloud-based solution** will yield substantial benefits for PC such as:

- Access to the best services available in the market;
- Ontime update both in terms of security and software functionality;
- Updates are accompanied with proper instructions on the use of the system;
- State of the art software available to PC and their customers;
- Compliance with local and international service quality standards such as ISO and DIN;
- Bugs, errors or malfunctions occurring in or during the provision of the services will be solved by an expert approachable on contact points and available round the clock;
- PC can free their IT staff from tasks regarding the CRM system;
- PC will become less vulnerable if programmers quit, take vacations or get ill.

These opportunities need to be assessed in light of the risks which come with such a solution. John must consider that a cloud-based CRM system provided by a third party and not by PC directly may give rise to customer concerns about data privacy, in particular if the service provider is a US-based company or the data are hosted outside the European Economic Area. Not every customer will see it as an opportunity rather than a challenge that their data are processed in a public cloud. In the long-run, however, possible losses of customers may be balanced by new, more innovative companies which are attracted by precisely these features of the new CRM system. PC can monitor the development of this correlation to learn about the impact of such features and to determine its future policies accordingly.

John will also have to analyze the pros and cons of going for an **off-the-shelf solution**. Despite the undisputable advantages of such products, they minimize the customer's possibilities to obtain the tailor-made solutions which have characterized PC's business model so far and thus may reduce its competitive advantages. Another

consequence John has to take into account is the product's resistance to being customized in the case of customer requests for specific features. Finally, it could turn out to be difficult for PC to analyze problems occurring in the off-the-shelf program.

The characteristics of off-the-shelf services are closely connected to the other characteristics of **contract automation**. The latter will substantially upgrade PC's service quality and the flexibility in its provision because PC will be able to provide its services swiftly, 24 h a day, and they will be more transparent as well as more easily monitored, upgraded, and downgraded. Again, this may make PC lose some loyal customers deploying the reduction in individual treatment, closeness to the service provider and the demise of traditional contracting patterns, but the overall increase in attractiveness will outbalance such losses.

5.2.2.2 John's Proposition

After considering the different options and the respective pros and cons, John's proposal to the Board of Directors regarding the new CRM system will be as follows:

1. A public cloud service provision will be chosen;
2. Contracting will be automated where necessary and feasible;
3. Data privacy and data security requirements must be met at the highest level;
4. Any service provider located within and hosting all customer data within the European Union will qualify; subsidiaries of US origin companies will be carefully assessed in this respect;
5. PC's business model and corporate governance policy must be modified accordingly;
6. Customers' consent to the changes must be obtained; they will be informed about the changes in PC's CRM system and the advantages it will bring them; customer response will be monitored and reported to Board of Directors;
7. The in-house provision of CRM services will be closed as soon as appropriate.

5.2.3 Making the Decision

It is assumed that the Board of Directors decided in favor of John's proposition.

5.3 Implementation

5.3.1 External Implementation

5.3.1.1 Regarding PC's Relationship with the Service Provider

Important aspects of PC's relationship with the prospective service provider will be determined by the conditions of the contract, or, in other words, this relationship and in particular the services to be delivered by the provider will be expressed in contractual terms.

Task 3: Explore PC's chances of being offered customized solutions and the effects this will have on their business model.
Unlike in the infancy of computing when service contracts were concluded individually, services nowadays are offered predominantly as pre-defined, pre-priced, and **ready-made service packages** leaving the customer with no possibilities to go for highly customized features. Certain providers may offer tailor-made solutions, but, as for the rest, customization is only offered for large clients or specific fields of service provision. For standard services and smaller companies such as PC, the market only provides solutions at acceptable costs that are off-the-shelf and can rarely be modified: the service provider transforms his business model into service packages and the customer only has the option either to take it or to leave it.

The pre-programmed service packages, the customers can choose, come with contractual conditions for every single service offered as well as for upgrades and downgrades. They appear as **click and wrap contracts**.

Contract Knowledge: Click and Wrap Contract
A click and wrap (or clickwrap) contract is an online contract to which a user must agree prior to using a service or a product. Users come into contact with it whenever they subscribe to a service available online, an email account or an online purchase, or when they download and install a software application. Often this contract is called End-User License Agreement (EULA).

The term clickwrap comes from shrink-wrap contracts dating back to the times when software was sold on discs packed in shrink-wrapped boxes labeled with something like "If you open the plastic, you agree to the terms and conditions of the license agreement inside."

The click and wrap contracts carry the providers' terms and conditions that specify what is being offered upon what conditions and for how long. They also contain information about the granting of rights, liabilities and other legal matters. Sometimes, provider conditions differ and thus allow the customer or subscriber to include the terms and conditions as a criterium for their selection decision.

For **further reading** on click and wrap contracts, see [3], [18] and [19], pp. 5–10.

Thus, click and wrap incorporates the service provider's pre-fabricated **Standard Terms and Conditions** into the contract which, in principle and in particular for smaller companies such as PC, are not negotiable. The pre-defined and ready-made nature of online services and packages eliminates the possibility, but also the need, for individually negotiated contracts. They replace the traditional contract and contain all relevant stipulations as well as necessary information regarding the services offered. Hence, PC will have to accept that the contract with the service provider will be closed in an automated way as **click and wrap contracts**, and according to the conditions stipulated unilaterally by the service provider.

Not only the service packages and the contractual conditions come prefabricated with clickwrap contracts, but also the way in which these services are provided and the quality objectives they must satisfy. These standards will be detailed in a specific part of the contract called **Service Level Agreement**.

Contract Knowledge: Service Level Agreement

A Service Level Agreement (**SLA**) is a contract upon which the service provider and the service customer agree for the delivery of the services. An SLA carries important information about the services and explains to the customer how the services are delivered and what the service limitations are. In general, an SLA will deal with the following issues:

- Delivery start date;
- Delivery end date;
- Service uptime (usually 99.99%);
- Service penalty (if the service delivery is not 99.99%);
- Service update notification;
- Service conclusion and migration of data;
- Trouble and problem reporting procedures and contacts;
- Service rewards if the customer continues the services once the initial contract expires;
- Service penalty if the customer pulls from the contract before the agreed upon time.

SLAs are pre-defined and automated as well, and customer's influence on the service standards is rather limited. They may, for instance, be able to choose between various grades of functionality and/or capacity, typically pre-packaged in e.g. gold, silver, etc. packages, but fine-grained customizing in most cases is not possible.

For **further reading** on SLAs and their automated management, see [20, 21].

Click and wrap contracts not only eliminate the customer's option to request a specific service provision but also reduce individual treatment if there is a malfunction or services are interrupted for a longer period of time. In such cases, the customer can refer to the Service Level Agreement (SLA) for any kind of entitlement or simply get in touch with the service provider.

Thus, John can only choose the pre-fabricated services packages offered by the prospective service provider according to his Standard Terms and Conditions and select the SLA version, if possible. However, he cannot get a tailor-made solution, as for example one that offers customized services or replaces click and wrap contracts through hard-copy contracts or even individually negotiated contracts.

Once this is clear to him, John will also be aware that click and wrap as well as automated service expansion and reduction will bring considerable change to PC's practice of relationship management, its business model, and possibly its governance policies.

Task 4: Identify the options that the service contract offers PC to cope with changing demands.
John will first of all analyze PC's need to adjust its provision of services to **fluctuations in volume** of requirements.

- PC has full year **peak requirements** for the CRM system. Although the number of customers served by the system will obviously fluctuate, this will have no effect on the demand of services or the conditions under which they are provided.
- If, however, due to changing numbers of customers or their performance requirements, PC needs to increase or decrease the **number of work stations** which access the CRM system, PC can simply use the dashboard to access their licenses, add or reduce the number of users, and pay subscription charges accordingly. Automated systems allow the customers to unilaterally modify the services they receive and autonomously calculate the remuneration due.

If PC needs to **modify the type of services** supplied, it can also do so by using the dashboard. For the delivery of SaaS applications, the service providers have all information programmed for each category of services they offer, and whenever the customer upgrades or downgrades the services delivered, the contract will update automatically. This procedure is provided by almost every service provider and reduces the time for offering services and concluding the contract and thus improves efficiency for both sides. Through the dashboard, PC can expand and equally reduce the services provided, for instance, go for additional features, increase the storage amount, buy in certain support services, upgrade as a premium customer, etc. They will get immediate notifications via email which are pre-programmed for predictable events and triggered by customer action such as signing up for a service for the first time, modifying services or cancelling services.

The service provider's response to PC's wishes for modification is thus realized through automated processes based on self-executing contracts, i.e. **smart contracts.** Smart contracts are dynamic and adapt to the changing requirements of the customers without the need for human intervention on the part of the service provider. Contrary to traditional practices in which contracts address humans regarding the agreement to a transaction and its execution, in cloud-based applications, software or service upgrades and expansion of services which legally require the consent of the involved parties and thus an amendment of the contract are now pre-empted on the service provider's side through the programming and activation of the software application.

If PC checks more services or adds additional users, they will **automatically be invoiced** the new price just as when they uncheck a service or remove a user. Apart from that, the terms and conditions of the services and the service contract will not be

affected. Finally, PC will get an email notification and a confirmation box will pop-up with each update. This way, they get an instant update for each service with mandatory terms and adjusted remunerations.

Task 5: Find out how the new CRM system allows PC to monitor services.
Online dashboards for CRM systems offer a **service monitoring** portal where PC's employees can log in anytime to see the company's subscriptions, the number of users logged in, service usage, service usability and the graph which guides the user for peak and down time for any of the services provided. The dashboard may differ from vendor to vendor depending on the nature of the software or the services delivered.

Moreover, dashboards provide a glance at **service metrics**. The latter allows PC to learn about their weaknesses and the areas in which they are falling short in terms of providing services to their customers or in customer satisfaction. Service metrics also enable PC to explore new opportunities and to gain insights into whether their customers are willing to pay more for the services provided. In cloud business, a typical example for the deployment of service metrics is the waiting time on phone calls before the customer representative reaches the service provider. Another example is the time it takes the service provider to resolve the issue and report the outcome to the customer which can take from a few hours to a few days up to a week.

5.3.1.2 Regarding PC's Relationships with Its Customers

The features of PC's relationship with its customers are largely, although not exclusively, reflected in the service contract it concludes with them. Thus, John has to consider the content of these contracts as well as the effects they may have on customer satisfaction and PC's relationship with individual customers.

5.3.1.2.1 Governance of Customer Relationships Through the Contract

Task 6: Elaborate on the possibilities PC's customers have to monitor their service modifications and to keep track of important deadlines.
Once the customers have successfully subscribed to the services, they receive service credentials to access PC's service portals. Using the dashboard, they can retrieve data about the market they are operating in which PC collects on their behalf as well as statistics about their products and services. The information is provided in the form of graphs and charts which are regularly updated. PC's customers can also access information about their competitors, use service portals for business analytics, and make business decisions based on these gained insights. This is how they can keep themselves in the loop about the market pulse.

The customer will **automatically be notified** of any important event occurring or approaching which has a direct or indirect effect on the services or on service subscription and which requires an appropriate response. Smart contracts autonomously execute this task. An example could be the monitoring of deadlines as well as the extension,

contraction or modification of services. Email services, colorful ribbons appearing on the dashboard and mail via post are examples of such notifications which allow the customer to learn about important updates and deadlines and enable him to act in time. For the most part, the notified persons will be the IT managers or any other individuals in charge of IT in any of PC's customer companies. Some customers will even include their finance department in the email list to keep them informed about imminent updates which require further investment or extra expenses.

Automated monitoring reduces the customer's and the service providers' efforts because they don't have to keep track of the current developments manually but it also mitigates the risk that important events are lost from sight. However, even if smart contracts come with great convenience for PC and its customers, the services and the contracts **still need human supervision**. Customers and PC both will have to monitor the service performance, keep watch of changes in the service requirements, and match the services accordingly if needed.

5.3.1.2.2 Management of Customer Relationships in General

Task 7: Make propositions to adjust PC's customer relationships to the new CRM system.

Service providers are constantly developing and updating their services. Usually, **service updates** are part of the services and the customers receive an email notification about any service bulletin or service update available. They come with terms of service or terms and conditions which open as a window where the customer can read them and decide whether to agree or disagree. Upon agreement, the customers have to proceed with the next step which is related to optional supplementary services such as whether the customer is willing to receive service update notifications or whether he or she agrees to contribute in service improvement procedures which allows the provider to collect and store additional data. All these procedures are the part of the online contract and usually take place when the customer installs the software. Subsequently, the update can be immediately seen on the service portal online whenever it is active. Furthermore, the customers will receive an email notification about the update.

Fundamental changes in the provision of services, as they happened in the present case because of the assignment of the services to a third-party provider using a public cloud, are not part of the ordinary updating processes. Thus, they cannot be implemented on the basis of a single-sided decision of the service provider but rather need the consent of the customer because PC promised to store and process the data in-house and this was a substantial part of the basis of the transaction.

PC has approximately 200 business customers ranging from SMEs to branch offices of international corporations. Typically, SMEs can be easily convinced to transition to the SaaS-provided solution. The IT governance processes and requirements of SMEs are less elaborate when compared to larger corporations, especially when the SMEs are not operating in sectors with increased information security and data protection requirements

(e.g. defense or healthcare). Therefore, PC's strategy for the SME customers will be to offer them financial incentives such as reduced fees and free consulting to transfer to the new solution. If an SME is still not convinced, PC will offer a 3-month transition period during which it will operate the old CRM system and then "sunset" it. This transition period is also necessary to accommodate large corporate accounts because IT governance procedures in bigger companies are complex and some of them require additional auditing of the new service before they are able to use it. An example for such a requirement is the standard SSAE-16 (Statement on Standards for Attestation Engagements No. 16).

In the case of a customer's withdrawal from PC's services, it is of particular importance to avoid **vendor lock-in** [22], one of the critical aspects when using SaaS. Very often vendor lock-in emerges when a user organization has created a substantial amount of data in a proprietary application and there is no easy way to migrate this data to an alternative solution. To alleviate this risk, John must have a close look at the offered import and export functionality of the different SaaS CRM systems.

5.3.2 Internal Implementation

5.3.2.1 Decisions to be Made

The introduction of the new CRM system will considerably interfere with PC's business model and governance policy but also with a substantial number of back office processes. Therefore, this measure needs the **approval of PC's Board of Directors**.

Since, in the future, services will be provided based on automated contracting and customer data will be hosted with a third-party service provider, PC must also modify its **governance policy** in a way that corresponds to the characteristics of the new CRM system. Such modification also falls under the competence of the Board of Directors.

Because of the variety of effects on other management functions, the internal implementation of the new CRM system will best be coordinated by a project team. The latter will, inter alia,

- consult with the **Sales Department** in order to figure out whether the planned changes are compatible with PC's relationship management strategy;
- consider measures to mitigate detrimental effects on customer relationships. PC can, for instance, organize a conference for their customers where they present and explain the planned modifications to their services and the positive effects this will have for the customers. Putting the conference online would also allow them to reach customers who did not attend. The main benefit of such events would be to prepare the ground for a positive attitude towards the new CRM system. Moreover, it will give PC the opportunity to learn about their customers' reactions immediately and to see whether they are open to such changes or not;

- coordinate the decision for the new CRM system with **Procurement** and **Finance and Accounting**;
- consult with **HR** regarding the future use of the employees who are currently regularly engaged in maintaining the CRM system;
- call in external l**egal expertise** in order to assess legal risks associated with the new CRM system and its implementation as well as to adapt processes, tools and terms and conditions to the changed legal conditions.

5.3.2.2 Establishment of the New CRM System

Task 8: Make suggestions for a smooth adaptation of the new CRM system with specific emphasis on the migration process.
The implementation process for the new CRM system requires diligent **planning** and a road map for the transfer of data from the existing system to the new one. The entire process needs mapping, organizing, and controlling. John can get help from PC's project management system for any kind of guidance and guidelines which may help him in meeting the important deadlines during the delivery process.

Once subscribed to the new CRM system, PC should immediately start the transfer process which can be done by either following an already existing **migration plan** or, if there isn't one, by preparing such plan. Generally, companies using a software system prepare a plan for how long they can use the system and how to retire it once it has reached its life expectancy together with a feasible migration plan. The migration plan is a tool of highest importance for any IT project.

There are various approaches for **migrating from an on-premise to a cloud-based service provision**. A review presented in Jamshidi et al. [18] assessed 23 different surveys carried out between 2010 and 2013, a period when migration to cloud-based services increased drastically. The authors classify migration activities into four categories: migration planning, migration execution, migration evaluation, as well as crosscutting concerns—an approach that is also reflected in the structure of the present case study. The evaluated surveys focused mostly on migration planning (18 studies), while migration execution and migration evaluation were addressed by 9 studies each. Crosscutting concerns (including security, governance and training) were the subject of 8 studies.

With its modified governance model, PC will be able to take in any new software provided by the service provider now and in the future. The system migration will take effect immediately for any system which is approved for an update or replacement, or qualifies as old and falls into the category of legacy system. In any of these situations, the migration takes effect under predefined guidelines which help the organization and the management to migrate the data from one data center to another. A further important aspect is the fate of customer data once a customer has decided to withdraw from PC's services. In such cases, the customer may be given a certain period of time, for instance three months, to migrate their data to their preferred destination.

Although this process may sound straightforward, there are several challenges in this field. The main problem which can occur is **lack of compatibility** between the old

system and the target system. Different platforms come with different environments and thus can temporarily block the adoption process and force the parties to stand still. Therefore, it is important to always keep an eye on system compatibility, system alignment, and the knowledge of the technicians involved who play a vital role in this process.

Also, such migrations are frequently planned to coincide with the release of a new version of the software. While this might appear to be a sound tactic because migrating to the new software directly saves one upgrade cycle, very often the release dates for large software products must be postponed, similar to the release dates of complex infrastructure projects such as bridges and airports. If such delays have not been considered adequately when preparing the migration plan, the organization may end up with an already cancelled contract for the old product while the new product will not be available for several months.

5.4 Process Optimization

The adoption of the new CRM system should cause PC to reconsider their governance policies as regards SaaS service provision and also for other fields of software application.

5.5 Actual Execution

PC's plan of action was carried out in a systematic manner. The selection process that John applied relied on the methodology of the analytical hierarchy process (AHP). Accordingly, a range of requirements was compiled, and these were classified in the following groups:

- Functional requirements—these define what functionality is expected from the system;
- Nonfunctional requirements (NFRs)—these define requirements such as how many simultaneous users the system supports, the response times of the system and its overall availability; they also include overall compliance requirements;
- Provider requirements—these include specific requirements regarding the provider, such as place of incorporation and applicable law, market presence, trainings, etc.

These requirements were ranked and assigned weights according to their relevance. More important requirements were given higher weights, less important ones—lower weights.

At the end of this process, representatives of the providers of the three top-placed CRM solutions were invited to present their products. Finally, the solution presented by Alpha GmbH was chosen.

It took PC three months to switch to the new CRM system provided by Alpha GmbH. First, the new SaaS system was introduced to PC's employees who were give a mandatory training on how to use it. In the second stage, the transfer of data from the old

system to the new one took place for the customers who agreed to use the new CRM system. This process was often burdensome, entailing non-availability of both the old and the new system for a certain period of time. However, times of lower business demand such as weekends and holidays were used to catch up. Another large roadblock in the migration process was the incompatibility of the new system with the IT infrastructure of some of its customers. This was notably the case where customers were using internet browser versions not supported by the new SaaS CRM system. All these issues could be settled by a quick response team set up by PC's IT staff to support customers in this phase of migration.

After three months, the CRM system of Alpha GmbH was fully functional without any complaints from the side of the customers. Thus, the requirements of PC's revised corporate governance policy were met. The latter states that with the purchase of the new software system, the old system should be replaced within three months unless the system was still needed, for instance, to support customers subscribed to the old system and not willing to switch to the new solution. All in all, PC experienced very few customers withdrawing from its services.

5.6 Learning Outcome

5.6.1 CM Value for the Case Study

In the present case, the CM Model was used to help John Douglas to properly analyse the situation with respect to contractual implications and to find adequate answers. It enabled him to better understand contracting and the contract lifecycle and allowed him to properly analyse the risks associated with the contract and their effects at the organizational level.

Since the CM Model includes all aspects of and related to contract handling, it was found to be particularly well-suited to deal with a **complex situation** such as in the present case, in which many stakeholders within and outside the company as well as a multitude of contractual relationships had to be considered under various circumstances. Thus, deploying the CM Model gives security that no important aspects are overlooked.

As part of the model, the **CM cycle** was used to identify management activities pertaining to the contract. For the Click and Wrap Case, these were contract planning, implementation and monitoring, all of specific relevance when adopting a new CRM system.

The model's showcasing of the **relevant management fields** guided John in particular to risk management which gave him systematic access to the issues involved as well as the methods for handling them. The aspect of risk identification brought to light inter alia the following risks:

- Loyal customers may withdraw from PC because of third-party service provision;
- Customers may lose confidence in data privacy because of the cloud solution;
- PC's competitive advantage could decline because of its limited possibilities to obtain customized CRM applications;
- Reliability and quality of PC's services provided to its customers will depend on the performance of a third-party provider.

The CM Model's emphasis on the subjects of management finally drew John's attention to the need for balancing the targets of PC (the enterprise) and their transactions (with its customers as well as with the service provider). It made him aware of the dependencies between PC's business model and governance policies, on the one hand, and its contracting model, on the other hand, which ultimately led him to ask for a strategic decision from the Board of Directors in order to optimize the interests involved.

5.6.2 Case Study Value for the Reader

This case study provides insights into the working of contracts within the highly digitized environment of SAAS service provision. It addresses forward-looking technologies such as cloud computing and solutions such as automated contracts and smart contracts.

The Click and Warp Case is **aimed at IT managers and CTOs** who find themselves in situations like that of John Douglas of PC who has to adopt a technical solution which is strongly related to contracts but has very little experience in contracts and contract handling. For them, the case study can serve as a first orientation regarding the issues involved and the ways in which they can be addressed in a systematic and organized way. They will become aware of the need to differentiate the steps that must be taken within their organizations and the measures that become necessary with respect to the external relationships involving customers and suppliers.

More specifically, the case study can provide insights allowing the reader to systematically approach issues common to **transactions based on digital contracts**. Questions raised and answered by the case study include:

- How can product or service changes be implemented in view of the binding effects of contracts?
- What must be considered if the processing of customer data is outsourced?
- What are the implications if traditional contracts are replaced by digital contracts such as click and wrap contracts?
- What is the leeway for negotiating services and contractual terms for digital contracts?
- How is performance monitoring carried out for an automated contract?
- How can service audit be done according to the contract terms?

The second focus of the case study is on the **adoption of a management system** with a significant impact on the company's core activities, in the present case a CRM system. Hence, specific attention is given to highlight the sensitivity of integrating new partners into service provision and the impact this may have on the business model and customer relationships. This topic reveals the high degree of complexity such decisions entail, and the manifold ways contracts and contracting models impact the possible solutions.

Finally, the reader may get an idea about the profound **changes the contract is undergoing** with regard to its presentation, content and handling due to the developments in information and communication technologies. Automation of contracts and in particular smart contracts are just at the beginning of their pervasion of business practice and, in the future, will affect the majority of business processes and business models. Already today they are an undisputable asset of managerial knowledge.

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6 The Contractual Sandwich Case—Managing Vertical Integration Through Contracts

Nikolaus Högenauer

Contents

N. Högenauer (✉)
Linde Engineering, Munich, Germany
e-mail: nikolaus.hoegenauer@linde.com

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Abstract

This case study deals with a large construction project within a US refinery and a defective piece of equipment, an undersized pipe rack. Questions are raised regarding who is responsible for the defect, who has to pay for the repair work and how the issue can be dealt with in a way causing minimal disruption of the project progress as well as the parties' business relationships. The case addresses in particular problems associated with a vertical enterprise network consisting of the plant owner, the main contractor and a subcontractor. This setting represents a multi-dimensional contractual management issue since the EPC contractor is bound in two directions: (1) by a main contract with its client, the plant owner, and (2) by an installation and construction contract with its subcontractor. As both contracts are partially overlapping, owner and subcontractor try to take advantage of the situation and influence the decision of the EPC contractor's project manager with the goal of benefiting from his decision. Therefore, only detailed knowledge of both contracts and a clever contractual management allow the project manager to make reasonable decisions and to enforce them effectively. But not only legal aspects need to be considered. To achieve the best results for his employer, the project manager needs to consider the impact of his decisions on the enterprise as a whole, i.e. on its corporate and financial management, its relationship with the owner and on its future business opportunities.

Keywords	EPC contract, subcontract, stand-by time, liquidated damages, extension of time, termination, substitution, de-scoping
Principle management topic	Enterprise networks
Institution	Large company, private, profit
Subject of management	Transaction
CM process step	Implement, evaluate
Management field	Management of transaction, knowledge management
Contract type	EPC contract

Editor's Note: For a full understanding of the CM Model's practical benefit for the case study, the reader may have to peruse at least Sects. 1.4.4 and 1.4.5 of Part I. The keywords used above to characterize the area of contract application are explained in the key system preceding the case studies in Part II.

6.1 Challenge

6.1.1 Set of Facts

The US-based gasoline producing company Oil and Petrol of the Americas Ltd. (Owner) is the owner of a 30-year old refinery in the state of Texas, USA. After such a long period of service, the refinery requires certain modernization and repair works. For this purpose, the Owner has entered into a contract (Main Contract) with the internationally known **EPC contractor** Consolidated Engineers GmbH in Germany (Contractor) which is now working on the partial revamp of the refinery. The contract value for the Contractor amounts to roughly US$ 100 million.

Contract Knowledge: EPC Contractor
In the field of international construction business, large construction projects are divided on high level into three work packages:

1. The engineering work ('E') which is necessary to design the object, to plan the work and to execute the project,
2. the procurement work ('P') which comprises the procurement services and the provision of equipment and material for the object, and
3. the construction work ('C') which represents the construction and installation of the equipment and material.

These terms are also used to describe the scope of a contract on high level. A contract which includes all three work packages is called an 'EPC contract,' and a contractor who executes such a contract is referred to as the 'EPC contractor.'

For **further reading** on EPC contracts, see [1].

As usual in this business, the Contractor uses a local engineering and construction company as subcontractor for certain works as well as for the construction and installation of the new equipment. For this project, the Contractor has chosen the local company Sullivan Engineering & Construction Ltd. (Subcontractor), a very experienced and well-known construction company. The Contractor, however, has not worked with the Subcontractor before. The value of the construction subcontract (Subcontract) amounts to roughly US$ 40 million and is based on the Contractor's standard terms and conditions of subcontracting. Part of the scope of work under the Subcontract is the reinforcement of the existing pipe rack to allow it to carry higher weights for additional piping and more electrical cables.

The contractual date for completion of the work is August 15. Both contracts, the Main Contract as well as the Subcontract, include this date as the penalized completion milestone. **Liquidated damages** for late completion amount to 0.5% of the contract

value per week in the Main Contract. The Subcontract stipulates liquidated damages for late completion of 0.5% of the Subcontract value per week.

Contract Knowledge: Liquidated Damages and Contractual Penalties

Liquidated damages or 'LDs' are pre-defined financial damages on which the contractual parties agree and which are payable by the defaulting party if certain contractual obligations are not met. Usually the contract will stipulate that LDs are the sole and only remedy in cases of such breach of contract and exclude additional claims for damages. LDs are mostly deployed in cases of a deviation from performance criteria ('Performance LDs') or time schedule, i.e. when certain progress milestones are missed ('Delay LDs'). LDs must be understood as financial damages which the parties pre-agree as being adequate and fair in order to avoid lengthy discussions on the amount of loss.

Contractual penalties, in contrast, serve the purpose of penalizing a breach of contract and are due regardless of any financial damage caused to the other party. Under common law jurisdictions, contractual penalties are considered void since they are regarded as unfair and unjust.

For **further reading** on LDs and contractual penalties, see [2] and [9], pp. 300–305.

During inspection on Monday, January 5, the project team of the Contractor discovers that the Subcontractor's reinforcement measures on the **pipe rack** are insufficient to carry the specified total load of 100 tons. The team informs the project manager of the Contractor (Project Manager) of its assessment. According to their calculations, the reinforced pipe rack, and especially the new installed steel supports, would not be able to carry the specified load of 100 tons in total, but only 95 tons.

Explanation: Pipe Rack

A pipe rack is a steel structure which carries and supports pipes and electric cables through a process plant. Since the pipes and cables need to reach almost all areas of the plant, it is usually built on levels several meters above ground. A pipe rack resembles a long bridge made of steel. Due to the large dimensions of a petrochemical plant, such pipe racks are required to carry a large number of pipes and cables and must support considerable weights.

During the daily site meeting on **Tuesday, January 6**, the Project Manager informs the construction manager of the Subcontractor (Construction Manager) of the new developments and his assessment. The Project Manager requests the Subcontractor to rectify the reinforcement immediately at its own cost since the detail engineering and the installation work for the pipe rack was part of the Subcontractor's scope of work.

The Construction Manager agrees that the reinforced pipe rack was designed and built to carry loads of up to 95 tons but refuses to repair it. He claims that the pipe rack was designed and constructed in strict accordance with the technical load specifications in the Subcontract. Raising his voice, he argues: "I have read the documents personally a dozen times and can assure you that I know exactly what is included in my scope of work. The pipe rack was specified by you to carry 95 tons and not more!" He further argues that if the reinforcement of the pipe rack was not strong enough, the reason could only be an error in the contract documents. In addition, he claims that even if the documents stated 100 tons of weight, the reinforced pipe rack built for 95 tons would "easily carry such additional loads" and that he did not understand the problem. A change in the reinforcement of the pipe rack at this point in time would not only lead to additional cost but also delay the overall project.

While listening to this reasoning, the Project Manager asks himself why the Construction Manager is arguing so strongly. If he really believed that he built the pipe rack in accordance with the Subcontract, he could act much more relaxed. The Project Manager realizes that, by stressing the issue of a potential delay in the overall project, the Construction Manager was referring indirectly to the EPC Contractor's liabilities towards the Owner to complete the project in time. He assumes that this referral may be used to build up pressure and to make him waive his request for the repair work.

This line of thought and the indirect threat by the Construction Manager alerts the Project Manager. He checks the Subcontract again and confirms that the technical requirements in the Subcontract documents do explicitly and unambiguously specify maximum weights of "100 tons" and not only 95 of tons as claimed by the Construction Manager. Thus, it becomes clear to him that the Construction Manager was quoting the Subcontract incorrectly, probably even intentionally in order to make him accept the extra cost. By referring to a potential delay of the overall project he had tried to push the Project Manager into a decision to the Subcontractor's benefit.

Therefore, the Project Manager once more requests the Construction Manager to initiate the rectification work without delay. He further instructs him to continue all work until the investigations concerning the required reinforcement measures are completed. Without giving any detailed reason, the Construction Manager disagrees and informs the Project Manager that until an agreement on this major technical issue is reached, the Subcontractor will stop all work to avoid further cost. In addition, he claims that the Project Manager has no right to "instruct" him to continue the work. He points out that the stop in work was clearly and solely caused by the Contractor, and that all consequences of the stop in construction concerning cost and schedule would be claimed by the Subcontractor under a variation order.

After checking the Subcontract, the Project Manager realizes that the contract does not give him the right to instruct the Subcontractor to continue the work. Still, he requests that the Subcontractor continues the work, and claims that if he fails to do so, all additional cost will be back-charged to the Subcontractor.

At the end of the site meeting, the Construction Manager at least agrees to perform the necessary investigations concerning the rectification measures and to come back to the Project Manager the next day.

After the site meeting, the Project Manager informs the Owner representative of the new technical challenges as well as the reaction of the Subcontractor. The Owner is not happy about this development and expresses his concern that the additional work and the dispute between the Contractor and the Subcontractor could easily delay the overall project which would cost the Owner several hundred thousand USD per week. Since the design and installation of the pipe rack reinforcements was in the scope of the Main Contract, the Owner requests the Contractor to start the repair work immediately even if the Contractor would have to bear the cost at the end. The project could not afford lengthy discussions between the Contractor and its Subcontractor. To support this request, the Owner representative refers to the contractual completion date in the Main Contract and the Contractor's obligation to meet the contractual milestones. He points out that in the case of delay, the Owner would claim the contractually agreed upon liquidated damages of US$ 500,000 per week.

Contract Knowledge: Contractor's and the Subcontractor's Obligations towards the Owner

A subcontractor performs work which the contractor owes to the client. However, as far as the legal relationship between owner and contractor is concerned, the subcontractor works on behalf of the contractor. He has no contractual relationship with the owner and is obliged only towards the contractor. For the contractual relationships in a project, see Fig. 6.1.

From the owner's point of view, it therefore doesn't matter whether work is executed by the contractor himself or whether the latter employs a subcontractor since, in either case, it lies in the Contractor's sphere of responsibility. In the case of a defect in the works, for instance, the owner can file a claim against the contractor (and only the contractor) to repair the defect and the contractor cannot object that the defect was caused by the subcontractor.

On subcontracts in general, see [3].

The Project Manager now finds himself in a "sandwich position," jammed between the Owner and the Subcontractor: The Owner does not accept any delay and tries to force the Contractor into speeding-up the project and into accepting the additional cost. The Subcontractor denies any responsibility for the undersized pipe rack and refuses to bear the extra cost. Both contractual partners are able to put pressure on the Project Manager in order to achieve their goals: The Owner is able to claim high damages under the Main Contract, while the Subcontractor is threatening to slow down and delay the work.

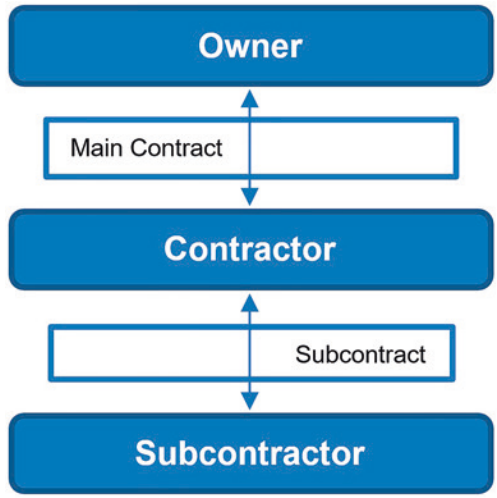

Fig. 6.1 'Contractual Sandwich' due to subcontracting

On the next day, **Wednesday, January 7**, the Construction Manager informs the Project Manager that the Subcontractor would agree to perform the required rectification work for an additional payment of US$ 900,000, and that the Subcontractor would start immediately once a variation order in this amount had been signed. However, the Project Manager would have to decide "immediately." If he delayed his decision, then the schedule would suffer and directly cause delay and additional cost. Furthermore, the Subcontractor claims that he could not re-start the work and its personnel and construction equipment would remain on stand-by in vain. Consequently, the Subcontractor would be entitled to compensation for cost caused by waiting for the decision as well as an extension of the completion time.

With reference to Article 10.3 of the Subcontract, the Construction Manager hands over an official variation order request of 45 pages, listing in detail all cost items which the additional work requires. The variation order request also includes a detailed schedule analysis showing the impact of the additional work on the original schedule, and the negative impact of a delayed decision of the Project Manager on the schedule. The Project Manager is surprised of the level of detail of the document. He informs the Construction Manager that he would reply as soon as possible. One of his team members indicates to the Project Manager that the review of the document may take up to one week due to the limited number of 'commercial experts' on site.

On **Thursday, January 8**, the Owner's Vice President of Operations calls the CEO of the Contractor and complains about the stop in work. She asks for an immediate settlement between Contractor and Subcontractor and, if this is not possible, requests that the

Contractor should bear the additional cost in order to assure the timely completion of the revamp project. She also refers to the high financial damages which the Owner would suffer if the project was delayed. She recommends starting the additional work as soon as possible, and stresses that the Owner would claim the full LDs in case of delay, i.e. US$ 500,000 per week.

After this conversation, the CEO informs the Project Manager of this call and urges for a swift solution to this situation. He asks what contractual rights they would have and what consequences the Main Contract would foresee in the case of delay. Finally, he requests that the Project Manager take the "appropriate actions" and keep him informed.

Since an agreement with the Subcontractor seems difficult, the Project Manager is uncertain what to do: whether to agree on the additional payment of US$ 900,000 to assure an immediate start of the repair work, or to remain firm and to insist on performance by the Subcontractor without additional payment.

6.1.2 Operating Procedure

6.1.2.1 Author's Explanations

Our case study highlights the different dimensions of the CM Model and its value for managerial decision-making.

(a) **Contract as a management instrument**: The contract forms the basis of the parties' cooperation and provides for the legal boundaries within which the parties can maneuver and make decisions. Thus, to a great extent, the decisions of the Project Manager depend on the wording of the contract. Or to highlight its negative impact: No contract partner is obliged to act in a specific way unless the contract provides for it. In our case, for instance, the Subcontract does not contain a clause which requires the Subcontractor to follow the instructions of the Contractor for continuation of the work. Thus, a respective clause should have been included in the text body of the Subcontract during the pre-award phase. The contract would then fulfill its purpose as a management instrument in this context as well and give the Project Manager the right to give binding instructions. The Subcontractor, in turn, could not argue against the wording of the Subcontract.
When it comes to shortcomings in project execution, no contractual party can assess who is liable for it and who has to bear the cost without knowing the contractual details. The Contractor must study the contracts carefully to find out what is contractually owed, and whether any additional work allows the Subcontractor to issue a variation order and ask for extra compensation. Without knowing the contract, the Contractor will struggle to convince the Subcontractor to perform the work at its own cost.

In addition, whichever party can quote a contractual clause in its favor will have fewer difficulties enforcing its rights. In this respect, it is more advantageous to refer to the contractual clause rather than the law since the contract has been negotiated by the parties and no party can claim that it was unaware of the respective obligation or liability.

(b) **The Contractual Management cycle**: For the time being, we find ourselves post-award in the **CM process step implement**. The Project Manager needs to implement the contract and use it as the primary basis for his decision-making.
After the decisions have been made during the CM process step implement, the processes, the actions and the results they produced should be evaluated (evaluate) and then be used for the planning (plan) and drafting of future subcontracts (draft). It is equally important to monitor the actual implementation process to be able to take corrective actions if necessary.

(c) **Contractual Management as part of the company's management system**: To make his decision, the Project Manager will require information from sources within his own organization (e.g. finance, risk management, upper management) as well as from outside sources (e.g. technical expertise, legal advice). This will allow a proper assessment and better understanding of the given situation. But information also flows in the other direction: from the project to the organization. Many decisions and actions on the corporate level depend on developments within the projects. To assess the consequences for the company, the colleagues working on the corporate level (e.g. in finance, risk management or upper management) depend on information from the projects, and the Project Manager needs to provide such information as required. Since almost all questions around risk, cost and liabilities depend on the underlying contracts, the details of such contracts need to be conveyed to the respective functions on cooperate level (**knowledge management**).
Contracts serve as important instruments for a company's **risk management**. Because nothing influences a construction company's financial result and its balance sheet more than the project outcome, the company's risk management and financial accounting always keep a close eye on the projects' risks and opportunities. And since the projects' success is highly influenced by the rights, obligations and possible liabilities, the contracts signed by the company directly impact the risk portfolio of the company. Business functions, such as finance, risk management or legal, must use the contracts to assess the risk situation and as a basis for decision-making in their own areas of responsibility. For example, the question whether a major claim to perform repair work is justified or not may influence the decision of the company's finance director to increase the financial reserves.
Even **corporate management** is influenced by the project contracts and their interpretation. Information on the project and its contractual basis must be conveyed to the corporate level, since the upper management may take certain actions to mitigate

the risk, or to adjust the company's corporate reporting. In significant cases, an unexpected development in a project may even lead to an ad hoc notification to the stock markets. In the case of a major dispute with a client or major subcontractor, the upper management will most likely ask for an interpretation of the contract in order not to jeopardize the relationship with the contractual partner.

(d) **Multi-dimensional Contractual Management**
To add even more complexity, the management of a company is often not only influenced by a single contract, e.g. by a sales contract with a client. Instead, many companies will find themselves in a sandwich position, where the optimum solution is not only defined by the sales relationship, but also by other related contracts, such as subcontracts, purchase orders, license agreements, or rental agreements as well as the respective relationships. The appropriate action towards one business partner in many cases cannot be assessed independently but must be based on a holistic examination of all relevant contractual relationships which may impact or be influenced by the action.

6.1.2.2 Reader's Tasks

You are the Project Manager. Identify the decisions you must make and answer the questions below. When necessary, use the contract excerpts of the Main Contract and the Subcontract included in the Materials at the end of this case study.

Question 1: Who has the contractual obligation to repair the pipe rack? (Level of difficulty: Low)
Question 2: Can the Subcontractor claim US$ 900,000 for the repair work? (Level of difficulty: Low)
Question 3: Can the Subcontractor claim for the cost caused by waiting for the decision of the Project Manager if the latter does not immediately agree to pay? (Level of difficulty: Medium)
Question 4: Can the Subcontractor claim for an Extension of Time if the Contractor does not sign the variation order on the same day? (Level of difficulty: Low)
Question 5: Should the Project Manager follow the Owner's request and agree to bear the additional cost? (Level of difficulty: High)
Question 6: Since the Subcontractor refuses to perform the work at its own cost, should the Project Manager terminate the subcontract? (Level of difficulty: High)
Question 7: What actions towards the contractual partners and within his own organization should the Project Manager take? (Level of difficulty: High)
Question 8: What should the Contractor's organization learn from this conflict and what improvements should be implemented? (Level of difficulty: Medium)

6.2 Decision-Making Process

6.2.1 Identification of the Decisions to be Made and Evaluation of the Decision-Making Circumstances

6.2.1.1 Decision-Making Options

After assessing the situation, the Project Manager is aware of the different options he has. He may

- grant the variation order and pay the Subcontractor's claim;
- reimburse the Subcontractor for its cost for standing time;
- grant the Subcontractor a time extension;
- remain firm and claim for LD because of the Subcontractor's delay;
- remain firm, terminate the contract and file a claim against the Subcontractor for cost and damages;
- remain firm, substitute the Subcontractor and claim for financial damages.

6.2.1.2 Decision-Making Circumstances

6.2.1.2.1 Importance of the Decision

The Project Manager's decisions will have a great impact on the further execution of the project and on the relationship with the Subcontractor as well as with the Owner. They may also have consequences for the Project Manager himself since he is accountable for the project success and a negative outcome may negatively impact his relationship with his superiors. If the Project Manager decided to accept the Subcontractor's claim and to pay the requested amount, and his decision was later assessed to be wrong, the Contractor would have paid US$ 900,000 without a valid reason, the financial result of the project would suffer, and the Project Manager would face difficult questions from his superiors. On the other hand, if the Project Manager refused to pay the claim even though the Subcontractor had a legally valid claim, the Subcontractor would be justified in discontinuing further performance of the work. Due to the expected lengthy discussion between Contractor and Subcontractor, the project would probably be delayed, and its outcome could possibly suffer even more. In such a case, the contractual deadlines would not be met, the Owner would claim LDs, and the relationship with him would suffer. In consequence, a wrong decision may result not only in a legal conflict with the Subcontractor, but also have a major impact on the overall project with risk and cost exceeding US$ 900,000 by far. It is therefore of major importance for the Project Manager to come to the correct decisions which are legally valid as well as practicable in the given business context.

6.2.1.2.2 Impact on Corporate Processes

As already mentioned, the decisions to be made by the Project Manager will directly influence other management processes of the company: corporate risk management,

claim management, legal management, finance and corporate management. For example, the finance department may have to allow for contingencies or financial reserves not only on the project level but also on the corporate level, and the risk management department may see the necessity of conducting a workshop to support the project at an expert level.

6.2.2 Preparation of the Decision

6.2.2.1 Identification of Required Information

To make legally and commercially sound decisions, the Project Manager requires various information and will rely on several sources of advice and guidance.

- As a main source of information, the Project Manager will use the relevant **contract documents**, i.e. the Main Contract between Owner and Contractor and the Subcontract between Contractor and Subcontractor, including attachments and appendices. He may also need documents produced during project execution, such as minutes of meetings, protocols, certificates, etc. He must read all such documents, understand them thoroughly, and be able to interpret them from a legal as well as business point of view. Since the questions raised relate to the legal core of the contracts and may be difficult to answer, the Project Manager should seek legal advice either from the contract management department, the legal department, or from the procurement organization (depending on the company's set up). Even legal advice from external lawyers or experts may be necessary.
- The Project Manager should share the relevant issues and the possible solutions with his employer's **business development and financial experts** in order to assess the impact of the relevant decisions on the financial or business level of the company.
- The Project Manager needs all possible information on the potential cost of the repair work and auxiliary cost. He cannot rely on the information provided by the Subcontractor but must involve his own **cost experts** to assess such cost from an objective perspective.
- Another source of information is the management of his company. His superiors (or **upper management**) may request that decisions are made not only on the legal grounds of the contracts, but also based on other facts and possible developments, such as future business dealings with the Owner or a possible loss of reputation. Therefore, the Project Manager must involve his superiors and possibly even the top management in the decision-making. It would be wise to consider the contractual, relational and commercial facts and consequences and to propose a set of decisions for the final approval of his superiors, thus interlinking the management of transactions with corporate management.
- Since the decisions not only influence cost but may also affect the project schedule, the Project Manager needs all information on the expected schedule impact of the possible decisions. Their effects must be forecasted and the most likely developments

must be compared in order to come to an objective, optimal decision with respect to the schedule. For such assessment and forecasting, companies use their **scheduling experts**; additional support from external experts may be necessary, too.

- The fact that the Subcontractor presented a 45-page document to support his claim must not influence the detailed assessment by the Project Manager. He should not draw the wrong conclusion by being influenced by the sheer volume of facts stated in a claim document since the Subcontractor will try everything to convince the Project Manager to bear the cost. This could involve the omission of information, lies, or intentional misrepresentation of contracts or documents. Therefore, even though the documents provided by the Subcontractor should be read carefully, the **validity of such information must always be challenged**.

6.2.2.2 Decision Processes

Whether the Project Manager is required to involve other departments or his superiors depends on the company's authority matrix. However, even if he is authorized to make such decision on his own, he should involve legal experts to cross-check his legal assessments. Furthermore, he should involve the upper management in the final decision for three main reasons:

(a) Since the amounts in question are very high, he should back-up his decision with the approval of his superiors.
(b) Depending on the outcome of his decision, the relationship with the Owner may suffer in the long run and thus jeopardize future projects and business opportunities. Therefore, upper management should provide the necessary guidance in this respect.
(c) His superiors may wish to be involved in steering the decisions on the corporate level not only to support the interest of the single project but to safeguard the overall interests of the company.

6.2.2.3 Decision Recommendations

Before the Project Manager can make a decision, he has to consider different questions (in our case study mainly the questions mentioned under Sect. 6.1.2.2) which will guide his reasoning. In most cases, there will be multiple ways of answering such questions. Therefore, he must assess the benefits and negative effects of each alternative and then decide on the most effective one. Such balancing of pros and cons can be complicated since most effects lie in the future and are uncertain. They must be predicted and forecasted with the available information at hand. Legal, business and social aspects have to be taken into consideration in every case.

Question 1: Who has the contractual obligation to repair the pipe rack?

The Project Manager's analysis of the relevant clauses in the Subcontract showed that the technical specification for the load of 100 tons in the Main Contract (see „Appendices, Attachments", Attachment to MAIN CONTRACT, A., Part 6) is exactly

the same as in the Subcontract (here Attachments to SUBCONTRACT, 1., Chap. 14). The Subcontractor even admitted that the reinforced pipe rack would only support a maximum load of 95 tons. This is in clear contradiction to the specifications listed in the Subcontract. Consequently, the structure does not fulfill the contract's quality requirements and is therefore defective. According to Article 8.2 of the Subcontract, the Subcontractor must rectify such a defect.

Question 2: Can the Subcontractor claim US$ 900,000 for the repair work?
As just demonstrated, the Subcontractor is responsible for executing the repair work. According to Article 8.2 of the Subcontract, the Subcontractor must perform the repair "at its own cost" and therefore cannot claim such additional cost from the Contractor.

Question 3: Can the Subcontractor claim for the cost caused by waiting for the Contractor's decision?
This question refers to two aspects of the contractor's actions that may lead to claims for compensation:

(a) Compensation for Stand-by Time in general: The Subcontractor claims that its effort to keep workers and equipment on site during the decision-making of the Project Manager will cause additional cost which the Subcontractor is entitled to be compensated for as **Stand-by Time**.

Contract Knowledge: Stand-by Time
Stand-by Time (or Idle Time) means time during which a subcontractor cannot work due to reasons caused by someone else but has to bear the cost of the personnel on site, for equipment, temporary site facilities and overhead cost. Therefore, a claim for 'Stand-by Time' refers to a claim for the cost and expenses. Such a claim can be granted under state law. Project contracts, however, will always provide for legal provisions in cases of disruption.

For **further reading** on disruption, see [4], pp. 762 et seq.

When assessing the validity of a claim, several issues have to be checked and clarified. A claim is only justified if it bears a valid cause, the effect is attributable to such cause and, when applicable, administrative requirements are met. The **conditions of a valid claim** are listed in the box below:

Work Aid: Valid Claim Test
1. Cause
   Cause means circumstances or events during project execution
   – which lead to a change in the contractually relevant facts,

- which are caused by an action or omission of the other party, and
- for which the other party is liable according to the contract.

2. Effect
   - The cause must have an effect on the project execution, meaning that it brings about a need to change the contractual terms, additional cost, or a delay, all of which have to be demonstrated and backed-up with comprehensible documentation.
   - The effect alone does not provide grounds for a claim but rather the claimant must also be eligible for compensation according to the contract or the applicable law.
3. Administrative requirements
   - The claimant has to demonstrate the contractual clauses (or legal regulations) which legally support its claim.
   - Furthermore, the claimant must follow all administrative requirements in the contract, e.g. the form of a claim, notification deadlines, and competences.
   - The claimant bears the burden of proof for all issues mentioned above and must present relevant and comprehensible evidence for such points.

When we apply the valid claim test to the Subcontractor's claim, we can see that not even the first requirement, 'cause,' is fulfilled. The direct cause for the Stand-by Time was the deficient work of the Subcontractor, the consequential need for repair, the Subcontractor's refusal to repair, and his decision to stop the work and wait, but not an act or omission of the other party, the Contractor.

(b) Compensation for delaying the response: The Construction Manager argued that the Project Manager would have to make an immediate decision and that the time the latter takes to come to a decision would cause a project delay and additional cost for the Subcontractor. The question is whether the fact that the Project Manager made up his mind after one week can constitute a basis for the Subcontractor's claim for Stand-by Time.

By application of a universal legal principle, a contractual partner must not delay the other party deliberately, and a decision on which the other party depends must be made without undue delay in order to save the other from a loss. The question is whether the Project Manager unduly caused such loss by not making an 'immediate decision' as requested by the Subcontractor.

The fact that it took the Project Manager one week to come to a decision can be seen as a normal consequence of the situation. Regarding the complexity of the question, the time of one week was not unreasonably long since it took several days to assess the content of the Subcontractor's 45-page variation order request as well as the legal and technical details. Furthermore, the Construction Manager himself had caused the delay by quoting the Subcontract incorrectly and by refusing to fulfill the obligations under

the Subcontract. In addition, it was the Subcontractor's own decision to stop the work during the dispute. The circumstances were, therefore, not caused by the Contractor.

Result Since the Stand-by Time was based on the deficient work of the Subcontractor and its decision to stop the work, the claim lacks a cause. The Subcontractor cannot claim for the cost of Stand-by Time.

Question 4: Can the Subcontractor claim for an Extension of Time if the Contractor does not sign the variation order on the same day?

Explanation: Extension of Time

An Extension of Time (EOT) means the adjustment of the project schedule and the shift of certain contractual milestones, often including the completion date, due to reasons which are not under the control of the subcontractor.

If the subcontractor suffers from project disruption or other obstacles for which the contractor is responsible, the latter is legally obliged to shift the respective milestone dates. If the project disruption was caused by a Force Majeure event, then the more specific clauses on Force Majeure apply and the dates must be shifted accordingly.

If the subcontractor has the right to an EOT and a schedule adjustment is refused by the contractor, under common law the original milestones may be regarded as invalid with the consequence that no completion date is owed under the subcontract at all.

For **further reading** on EOT, see [5].

The relevant clause of the Subcontract, Article 12.6, stipulates that the Subcontractor can only ask for an EOT if the delay in work was not caused by it. However as shown above, the extra work, the delay in work and the Stand-by Time were caused by the Subcontractor.

Result The Subcontractor cannot ask for an Extension of Time. The original contractual deadlines remain valid.

Question 5: Should the Project Manager follow the Owner's request and agree to bear the additional cost?

The Project Manager wonders whether, as requested by the Owner, he should enable the immediate start of the repair work by paying the Subcontractor the additional amount of US$ 900,000. Such a decision would also avoid a delay caused by contractual discussions and support the good relationship with the Owner. However, it may have a negative commercial impact on the project.

(a) Legal and non-legal aspects: From a purely legal point of view, the Subcontractor is responsible for the defect and has to bear the additional cost. But even if the Subcontractor is contractually liable to repair at its own cost, the Project Manager's decision to remain firm and to request rectification could still be the wrong choice. Therefore, a risk assessment for two alternatives is necessary:
   – signing the variation order and paying US$ 900,000 without legal reason, or
   – remaining firm and requesting performance from the Subcontractor with the risk of a delay to the overall project.

   The question arises as to what decision bears lower risk for the project budget, the overall project success and the Contractor's business targets. In consequence, both alternatives need to be reviewed in detail from a commercial and risk management perspective.

(b) Cost and risk aspects: If the Project Manager remains firm and requests the Subcontractor to perform the rectification at its own cost, this might cause a delay for which the Owner could claim delay LDs from the Contractor. Therefore, the additional cost of US$ 900,000 must be assessed against the risk of such delay LDs as well as the additional negative impact on the relationship with the Owner.

   In the main contract, the delay LDs owed to the Owner are US$ 500,000 per week. Since delay LDs in the Subcontract are 0.5% per week and the delay in question was caused by the Subcontractor, the Contractor could claim US$ 200,000 per week from the Subcontractor with a negative balance of US$ 300,000 per week as a risk with the Contractor. Thus the US$ 900,000 claimed by the Subcontractor would allow for a dispute and delay of up to 3 weeks (US$ 300,000 $\times$ 3 weeks).

   In our case study, the Subcontractor informed the Project Manager that the deadline could only be met if the extra repair work were commissioned immediately. As a consequence, the risk of a delay caused by the actual additional work itself seems rather low because the Subcontractor indicated that the work itself would not delay the project. However, the dispute between the parties and the time it takes to come to an agreement could cause further delay since the Subcontractor had stopped all work until an agreement was reached. Therefore, the Project Manager must assess the possible delay caused by the dispute and forecast which consequential time of delay may be realistic. He then has to multiply the number of delay weeks with the remaining monetary risk of US$ 300,000 per week to arrive at a monetary risk.

   If the Project Manager remains firm and refuses the variation order, it can be assumed that the Subcontractor will quickly give up his refusal and accept the additional cost since the Subcontract clearly allocates the liability to the Subcontractor. Thus, the monetary risk in remaining firm and continuing the dispute appears to be much lower than US$ 900,000 which would allow for a three-week dispute, as shown above.

   In addition, it must be taken into account that the payment of US$ 900,000 would be actual cost and not only a potential risk, and that the risk of an overall delay would

not be reduced to nil even if the Contractor paid the additional US$ 900,000. From this perspective, the risk in remaining firm and requesting the Subcontractor's performance appears acceptable compared to the payment of US$ 900,000.

(c) Reputation and relationship management: In addition to the financial risks, the relationship with the Owner as well as the Contactor's reputation as a reliable EPC contractor must be considered. A project delay is most often regarded as a failure of the contractor and thus should be avoided. The negative reputation of not being a reliable contractor would add to the Owner's frustration with the financial loss which he would suffer in the case of a delay. On the other hand, it must be taken into account that, in large-scale projects, every owner is aware of the fact that delay may cause him high loss. Since delay LDs are the sole remedy for delay, in most cases, they will not compensate all financial loss. Thus, the owner always bears the overall risk that a project might be completed late and that he may not be able to recover all cost from his contractor.

Since the defect was clearly caused by the Subcontractor, a reasonable project manager would hold the Subcontractor accountable for the rectification. The high amount of the Subcontractor's proposal makes a contrary decision even more incomprehensible. It can be assumed, therefore, that the Owner as a profit-oriented organization will understand the Contractor's decision to request the performance from the Subcontractor, and that the relationship will not suffer if the reasons are explained by the Contractor.

Result The Contractor should choose not to pay the additional sum of US$ 900,000.

Question 6: Since the Subcontractor refuses to do the work, should the Project Manager terminate the Subcontract?

With respect to the Subcontractor's refusal to work, the Project Manager has two alternatives: Either he holds the Subcontractor liable to perform the obligations as agreed upon in the Subcontract or he terminates the Subcontract and executes the respective work with the help of other contractors by way of **de-scoping or substitute performance**.

Contract Knowledge: Termination, De-Scoping, and Substitute Performance

Termination means the cancellation of the contract by one party. The terminating party must be legally entitled to do so by the contract or by the applicable law since contracts in principle are binding. In case of a termination, the parties become free from the further fulfillment of the contract and may make monetary claims against each other.

De-scoping refers to the taking away of parts of the subcontractor's scope of work, thereby reducing the scope of such work. It is a contractual remedy which terminates the contract for the respective part of the scope of work and can be regarded as a '**partial termination.**'

Substitute performance (or execution by substitution) is a concept under many legal systems but may also be stipulated in the contract. It allows the creditor to give the other party a last chance to cure a default and serves as a warning that otherwise the work will be performed by another company on behalf of the defaulting party and at its cost in the form of a substitution. In such a case, the contract is not terminated, and the defaulting party does not become free from its obligations but remains liable for breach of contract.

The benefit of the **substitute performance** lies in the fact that the subcontract remains in force and gives legal grounds to claim damages from the subcontractor, whereas in the case of a termination or 'de-scoping,' the subcontract (partially) ceases to exist, the defaulting subcontractor is freed from the contract and it will be more difficult to claim for damages. It must be noted, however, that under various jurisdictions substitute performance must meet fairly restrictive legal conditions.

For **further reading** on termination for convenience and de-scoping, see [6] and on de-scoping and termination [10].

In the case at hand, each alternative will produce different consequences. As long as the Subcontract is not terminated, the parties are bound by it, and the contractual rights and remedies remain available for them. If the subcontract gives a party more or better rights than the applicable law, the privileged party should not terminate the contract but exercise the rights described in the subcontract.

The Project Manager in our case is interested in getting the work done as quickly as possible on the Subcontractor's cost, and also in claiming his own additional cost from the Subcontractor. The Subcontract provides for such action in Article 9.4 and describes in detail in Articles 8 and 9 the rights and remedies which maybe be applied by the Project Manager.

Even though the applicable law may also give such remedies, its requirements are often not easy to identify or handle, in particular in an international context. In addition, a reference to a contract signed by both parties normally promises a higher chance of success if the case should end up in court or arbitral court.

Since the search for a new subcontractor could take several weeks, it would delay the project even more. Therefore, it appears preferable for the Project Manager not to terminate the Subcontract but to apply the rights described in the Subcontract. He should hold the Subcontractor liable with reference to Article 8 and Article 9 of the Subcontract to perform the work. If the Subcontractor refuses, he should substitute the Subcontractor and claim the additional cost, as defined in Article 9.

Result The Project Manager should not terminate the Subcontract. If the Subcontractor fails or refuses to execute the work as agreed in the Subcontract, the Contractor should substitute the Subcontractor and claim for the extra cost.

6.2.3 Decision

As a consequence of the reflections outlined above, the Project Manager should

- not respond to the claims of the Subcontractor for time and cost compensation;
- not accept to pay for the rectification work;
- not terminate the Subcontract;
- request the Subcontractor to perform the reinforcement at its own cost;
- if necessary, substitute the Subcontractor and claim any additional cost as financial damages.

6.3 Implementation of the Decision

Question 7: What actions towards the contractual partners and within his own organization should the Project Manager take?

6.3.1 External Implementation

After the Project Manager has made his decision to hold the Subcontractor liable under the Subcontract, several actions are necessary towards the Contractor's external partners.

6.3.1.1 Measures Regarding the Subcontractor

Based on his legal assessment, the Project Manager must send an official **notification of breach of contract** to the Subcontractor in the form of a letter signed by the Contractor.

Work Aid: Notification of Breach of Contract

The notification should include the following items:

1. The main facts and the results of the Contractor's assessment of the contractual obligations.
2. A reference to the contractual clauses supporting such assessment.
3. A request to reinforce the pipe rack at the Subcontractor's own cost.
4. A request to immediately resume all remaining work and to complete without delay.
5. A deadline for the completion of the reinforcement work.
6. A clear statement that the Contractor may execute the Subcontractor's obligations by substitution (with reference to Article 9 in the Subcontract) at the Subcontractor's cost if the latter should fail to meet the deadline.
7. A warning that all additional cost would be claimed from the Subcontractor as financial damages.

After submission of the notification, the Project Manager should avoid discussing the matter further with the Subcontractor's representatives since it may weaken the firm statement as described above.

6.3.1.2 Measures Regarding the Owner

In order not to jeopardize the good relationship with the Owner, the CEO of Contractor should send a letter to Owner's VP-Operations to explain the factual situation, its legal assessment, the cost situation and the recovery plan. He may also choose a telephone conference to personally explain the decision and the measures taken. He should inform the VP of the legal assessment and the decision made by the Contractor to request the Subcontractor to fulfill its contractual obligations. The CEO should underline that the fault was with the Subcontractor, which has the legal right to rectify the work on its own cost, and that the significant cost of US$ 900,000 cannot be borne by the Contractor without legal reason. Finally, he should give reassurance that the Contractor will support the Subcontractor in performing the remaining work to meet the contractual milestone dates.

6.3.2 Internal Implementation

Besides the actions taken towards the contractual partners, the Project Manager also needs to internally communicate and implement his decisions, including in particular the following:

- He will inform **his superiors** of the steps taken to implement the decisions and of the communications towards the Owner and the Subcontractor;
- He must assure that all relevant information, communication and other data concerning the above decisions are **collected and stored for documentation** and evaluation purposes as well as for possible legal proceedings.
- Together with the project **cost controller**, he will revisit the project risk analysis and assess the required adjustments in the project's cost reporting, since every unexpected development in a project, whether positive or negative, has an impact on the risk assessment and the necessary project risk contingency, which is the reserve in the budget for unforeseen cost. If a potential risk is resolved or reduced, the risk contingency in the project budget can also be reduced, which increases the expected profit. In contrast, if a risk arises or increases, then the risk contingency must be adjusted accordingly.
- The Project Manager will inform the **finance department** about the dispute and possible developments. In certain cases, the company management may decide to create financial reserves on corporate level in addition to the risk contingencies included in the project budget. Therefore, information on the possible legal proceedings should be given to the business functions finance and risk management, depending on the internal corporate guidelines.

- The Project Manager will stay in close contact with his colleagues from **contract management** or the **legal department** concerning the next steps in order to align further communication and actions.
- As part of a professional subcontractor management, the Project Manager will assure that an **internal appraisal of the Subcontractor's work** is performed and communicated, and that such appraisal includes warnings on the Subcontractor's behavior for future projects. In serious cases, the Contractor's organization may consider banning or "blacklisting" the Subcontractor from future projects.

6.4 Process Optimization

Question 8: What should the Contractor's organization learn from this conflict and what improvements should be implemented?

6.4.1 Contract Planning

6.4.1.1 Lessons Learnt on Standard Terms and Conditions

The performance of the contract and its provisions must be evaluated after project completion during the CM process step evaluation. Especially in the case of conflicts in the course of project execution, the project team has to **evaluate** the relevant provisions in detail and must decide whether the company's Standard Terms and Conditions need to be amended or changed. If legal checklists or risk checklists exist for reviewing contracts, they also should be revisited and lessons learnt be implemented accordingly.

During the process step **draft**, lessons learnt from previous contracts must always be considered. However, one should not try the impossible. If contracts attempt to handle each and every potential problem in detail, they become too large and un-readable. Therefore, good judgement is required to identify the most critical contractual issues. It must be carefully defined which risk should be addressed in detail in every contract document and which risk can be covered in more general clauses.

In obvious or high-risk cases, it may be necessary not to wait until project completion, but to evaluate the contract even during project execution and to approach the contractual partner with the request to change a certain clause of the present contract even during project execution, e.g. to achieve clarity or to match two contradicting clauses. Even though many contractual partners will refuse to change the contract at the other party's request, it must be considered in risky situations.

6.4.1.2 Example: Right to Give Binding Instructions

As a possible result of the lessons learned analysis, the Contractor organization may decide that all future subcontracts should include a clause, which assigns the Contractor's project manager a right to give binding instructions to its subcontractors

in case of major differences, especially if these could jeopardize the project progress or success.

6.4.1.3 Better Synchronization of Main Contract and Subcontract

The gap between the delay LDs in the Main Contract (US$ 500,000 per week) and the delay LDs in the Subcontract (US$ 200,000 per week) remains as a risk for the Contractor. From a risk management perspective, it would be beneficial for the Project Manager if he could claim the same amount from the Subcontractor as he owes to the Owner. A synchronization of both contracts could be the solution to close such a gap.

Contract Knowledge: The Use of Standard Terms vs. 'Back-to-Back'

Since the contract documents for the main contracts are normally provided by the owners, they are never the same. Only seldom will the contactor be able to use its own Standard Terms and Conditions in a main contract. This results in a gap between the main contract and the Standard Terms and Conditions which the contractor applies to its subcontracts.

To bridge this gap, the contractor has two main choices when planning its subcontracting strategy: Either (1) use its Standard Terms and Conditions without adjusting them to the respective main contract. In this case, the contractor must accept inconsistencies of the two contracts in risk and liability and allow for respective risk contingencies in the budget. Alternatively (2), the contractor can align the subcontract with the respective main contract and mirror its risks and liabilities. In this case, we speak of drafting 'back-to-back'.

Both alternatives have advantages and disadvantages:

- The use of the contractor's Standard Terms and Conditions allows the project team to work easily with each new subcontract. No familiarization or training for each new project is necessary. Subcontracts can also be placed much more quickly when not requiring a full adjustment to the main contracts, which always differ. As a disadvantage, the contractor has to accept a higher risk caused by the gap between the contracts' terms and conditions.
- A 'back-to back' solution reduces the contractor's risk, but requires much more work and legal knowhow on the project team level since the relevant clauses of the individual main contract need to be legally examined and then applied to the legal bodies of the subcontracts. Close cooperation with the sales and legal department is essential since a change in one clause often results in the necessity to also change other parts of the subcontract.

For **further reading** on the issue of synchronizing main contract and subcontract, see [7] and [8], pp. 251–253.

As a possible improvement and lesson learnt, the Contractor organization may consider increasing the percentage of the delay LDs in the subcontracts. This could reduce or even avoid a gap between the LDs owed to the owner and the LDs which can be claimed from a subcontractor. The smaller the gap, the smaller the commercial risk for the Contractor.

As shown in the contract knowledge box above, both alternatives (the use of standards terms and the deployment of the main contract back-to-back) have their weaknesses. An acceptable and feasible compromise may be the use of Standard Terms and Conditions as a starting point with an application of certain critical clauses 'back-to-back.' For example, a 'back-to-back' adjustment of the LDs could be easily realized as long the legal clauses themselves remain unchanged. Another good example of an easy adjustment is the alignment of the limitation of liabilities or of the insurance sums. However, once the legal content of the subcontract clauses is changed, the subcontract manager needs to check the entire subcontract for legal inconsistencies.

But even if the Contractor's organization opts for the back-to-back solution for certain liabilities, it may not always be advantageous to have an increase of the liabilities in the subcontracts in order to reach the same monetary sums as in the main contracts. The reason for this is the much smaller contract value of the subcontracts in comparison to the main contracts. In our case, the contract value of the Main Contract is US$ 100 million and the LDs 0.5% per week amount to US$ 500,000 per week. Compared to the Subcontract value of US$ 40 million, an increase of the LDs to US$ 500,000 per week would push the Subcontractor's liability to 1.25% per week and therefore more than double the risk. Such an amount would either be unacceptable for the Subcontractor or it would increase its risk and therefore the Subcontract price. A reasonable balance of cost and benefit, however, is essential if the terms are to be used "back-to back."

6.4.2 Contract Drafting

When drafting subcontracts, the Contractor's organization must assure that the valuable lessons learnt from previous projects are taken into consideration. Legal checklists or risk checklists have proven to be useful and effective tools for educating on legal lessons learnt and for assuring that such aspects are checked for each new contract. Checklists are living documents which include identified legal risks and possible mitigation measures in the contractual documents and are updated periodically. Quality assurance processes should ensure the application of such checklists. It may also be appropriate to make the signed checklist an internal precondition for finalizing a contract.

When drafting a subcontract with the same subcontractor, the respective subcontract manager should not only use previous lessons learnt and checklists, but also investigate previous experiences with the subcontractor in past projects and its behavior in cases of disputes. Most companies have an appraisal system in which such experiences are registered and documented for future use. Past experiences should be considered when

drafting subcontracts, either to make them stricter or to ease the standard terms resulting in lower prices.

6.4.3 Contract Monitoring

In our case, the subcontractor tried to use the contract for its benefit and presented a 45-page claim within a very short time. At first, the Contractor's team was surprised and overwhelmed by this action and the sheer volume of the claim document. The submission of an extensive document may give the impression that the claim is justified; but the volume of text alone does not justify the claim. If the commercial team on the Contractor's side has not been prepared to handle such behavior, this may lead to hasty and wrong decisions.

Contract Knowledge: Aggressive Claims Management
Some companies are not interested in achieving a well-balanced and fair relationship with their partners, but try to use the contracts to their benefit, i.e. to create additional revenue or profit ("your loss is my profit" instead of a "win-win" setting). They deploy and often twist it to enforce variations or concessions against the other party, or the other party is flooded with claims and extensive documentation which cannot be easily handled. Often large manpower capacities are mobilized to produce a high number of claims and overwhelming documentation. Numerous 'claims managers' or 'change administrators' join the project to document and report each and every of the partner's deviations from the contract. This enables the subcontractor to file claims and variations quickly and in large numbers and often puts the other party under pressure to agree on a settlement without having a chance to assess all claims in detail. Since all contracts contain commercial gaps and loopholes, such an approach can be successful if no effective defense is in place. In addition, some companies and individuals see claim management as a personal challenge and a sort of sport. Successful claim management is perceived as a personal achievement and sometimes leads to questionable actions or even unfair behavior.

If the attitude described above is noticed and the other party follows a more cooperative approach, the party risks being exploited or overrun by innumerable claims. Instead, it has to adapt a different project management approach: claim management, claim defense, documentation and follow-up management should be intensified, the team enlarged and commercially trained.

Coming back to our case study: If a subcontractor is able to produce a detailed 45-page claim document overnight, then this should give the Contractor an indication that the Subcontractor's organization may be set up for a more challenging or even aggressive claims management. Consequently, the Contractor's project team should monitor closely

how the contractual partner reacts and adjust its actions accordingly. If its assessment supports the impression of an aggressive claim management, the Project Manager should not wait too long, but inform the upper management of his findings and request further support and manpower for the project to defend against such claims.

6.5 Actual Execution

On Monday, January 12, the Project Manager handed over to the Subcontractor an official letter of breach of contract with a deadline for the completion of the repair work and a warning that, in case of default, a contract would be placed with another subcontractor, and all cost would be claimed from the Subcontractor as financial damages. Reference was made to Art. 10.3 of the Subcontract. The Subcontractor's claim for cost and EOT was rejected with reference to Article 12.6 of the Subcontract.

In addition, the CEO sent a letter to VP-Operations of the Owner and informed her that the Subcontractor was responsible for the defect and the delay, and that immediate execution of the repair work had been requested. He further underlined that the Contractor would support the Subcontractor so that the contractual deadline could be met and that this issue would have the highest attention of the management.

On Wednesday, January 14, two days after the receipt of Contractor's official notification, the Subcontractor agreed to perform all necessary work at its own cost. The project was completed with a delay of two weeks caused by the defect in the pipe rack. The Contractor succeeded in recovering US$ 400,000 from the Subcontractor as delay LDs but had to pay the Owner LDs of US$ 1,000,000. The balance of US$ 600,000 was booked as cost on the project. By making the correct decision and not submitting to the Subcontractor's claim of US$ 900,000, the Project Manager saved his company US$ 300,000.

It turned out later that the engineering work performed by the Subcontractor had been correct, but the steel supports supplied by its vendor had been partially wrong. Since the delivery documents showed the correct technical data of the steel supports, and Subcontractor's warehouse staff performed only spot checks, the defect was not discovered before the supports were installed. The Subcontractor's construction management obviously tried to disguise this default.

6.6 Learning Outcome

6.6.1 CM Value for the Case Study

Our case study highlights the fact that every project produces a large number of business, legal and relationship issues during its lifetime. The CM Model helps provide an understanding of all contract-related issues as an integral part of project and corporate management.

The CM Model, with its multi-dimensional approach, demonstrates that contracts influence not only transaction management but also corporate management and risk management decisions. They impact the financial management of a company, the relationships with clients and the key account management. In many cases, contracts will define procedures to be followed by the parties when action is required. Understanding such interdependencies helps the project team make correct decisions, communicate well, involve the relevant persons, and comply with predefined processes.

In cases of a vertical integration, i.e. when a company finds itself jammed between two other contract partners, contractual management gets even more challenging since the multi-dimensional CM Model must be applied in two or even more directions. This increases the complexity of the decision-making situation even further and requires a cross-sectoral and networked thinking and communication.

The CM Model also helps provide an understanding of the interlinked CM process steps evaluate—plan—draft—implement—monitor. As shown in our case study, the process steps implement and monitor lead to evaluate, in which the project team has to assess the lessons learnt for future project planning and contract drafting.

6.6.2 Case Study Value for the Reader

The Contractual Sandwich Case should enhance the reader's understanding of management issues in many respects:

- It demonstrates the necessity to **be familiar with the relevant contractual documents** throughout the term of a project since they influence major project decisions as well as day-to-day issues and actions.
- Knowledge of the contractual terms and awareness of their relevance should rest with **each project team member**. Contracts should not be seen as difficult and "only for the lawyers," but instead should be read and understood in detail by each member. Otherwise it may be too late if it comes to a legal dispute.
- In projects as in other forms of business, contractual partners may try to make **unjustified claims** by misinterpreting the wording of the contract or by referring to wrong or incomplete facts. In such cases, only an accurate understanding of the contract and assessment of available facts can lead to a correct decision.
- Working on "mutual trust" is a goal common to many companies, but it can only be achieved if both parties follow this approach. **Blind trust must be avoided** when assessing facts or making commercial decisions, especially in new business relationships.
- Putting pressure on a contractual partner is often used to influence a decision in a certain direction. When pressure is applied by owners or subcontractors or from both at the same time, the project team must remain calm and take the necessary steps to achieve an optimal decision. **Being familiar with the contractual rights and remedies** upon project start will help the team to remain cool and act professionally.

- All decisions should be aligned with company goals and approved by the relevant **internal experts and stakeholders**. The level of involvement from other departments depends most often on the monetary value of the project, but may also relate to other factors as demonstrated in this case.
- All **company representatives should be well-trained** in commercial and contractual matters. Not only are they the first line of defense, but their actions often have a direct impact on the success of a claim or claim defense and thus on the outcome of the transaction.

Appendices

MAIN CONTRACT (excerpts)

7. Defects

7.1 If the OWNER notifies the CONTRACTOR of the existence of any defect in the WORKS or non-compliance with the technical specifications, then the CONTRACTOR shall at its own expense correct, repair or replace such defect at the OWNER's preference and to the OWNER's satisfaction including the removal, substitution and reinstallation as necessary.

8. Delay

8.1 …

8.3 If the CONTRACTOR fails to meet the below milestones, then the CONTRACTOR shall pay to the OWNER the respective amounts as liquidated damages:
… 0.5% of the CONTRACT SUM per week …

8.4 The CONTRACTOR'S cumulative liability for delay shall be limited to 10% (ten per cent) of the CONTRACT SUM.

8.5 OWNER may deduct any due liquidated damages from the CONTRACTOR'S invoices, and shall notify the CONTRACTOR accordingly.

Attachments to MAIN CONTRACT:

A. Scope of Work

Part 1—General:

…

Part 6—Pipe Rack:

The Contractor shall perform all necessary detail engineering services, provide all required material and installation work to enforce the existing pipe rack as specified in the Owner's technical specifications. The reinforced and extended Pipe Rack must allow for loads of up to 100 tons.

SUBCONTRACT (excerpts)

Article 8—Remedies

…

8.2 The Subcontractor guarantees that the WORK will be performed in strict compliance with the SUBCONTRACT document and the specifications attached to it. The SUBCONTRACTOR shall rectify any defect and any non-compliance with the technical specifications at its own cost, by repair or replacement, including the removal, replacement and reinstallation of the respective equipment and material.

8.3 …

Article 9—Execution by Substitution

9.1 If the SUBCONTRACTOR fails to fulfil any of its obligations under the SUBCONTRACT, including
implementing the CONTRACTOR's instructions pursuant to Article 8 (Remedies), or
taking adequate measures to recover a delay, or
…,
then the CONTRACTOR shall notify the SUBCONTRACTOR in writing accordingly and set a deadline for completing the requested work.

9.2 If the SUBCONTRACTOR fails to comply with the CONTRACTOR's notification as per Article 9.1. above within the time given therein, then the CONTRACTOR shall be entitled to take the respective actions to complete the WORK in whole or in part by itself or by a THIRD PARTY, at the risk and expense of the CONTRACTOR ("EXECUTION BY SUBSTITUTION").

9.3 In the case of EXECUTION BY SUBSTITUTION, the CONTRACTOR is not obliged to pay the SUBCONTRACTOR for the WORK performed under EXECUTION BY SUBSTITUTION.

9.4 In the case of EXECUTION BY SUBSTITUTION, the SUBCONTRACTOR shall reimburse the CONTRACTOR for all expenses exceeding the cost which would have become due to the SUBCONTRACTOR under the SUBCONTRACT for the respective WORK.

9.5 In the case of EXECUTION BY SUBSTITUTION, the SUBCONTRACTOR remains liable for all warranties, liabilities and obligations under the SUBCONTRACT, to the same extent as if the respective WORK had been performed by the SUBCONTRACTOR.

Article 10—Changes and Variations

…

10.3 When the CONTRACTOR orders a change to the WORK or additional work ("VARIATION"), and the SUBCONTRACTOR is of the opinion that

such entitles to a change in the SUBCONTRACT PRICE and/or PROJECT SCHEDULE, the SUBCONTRACTOR shall submit a VARIATION ORDER REQUEST to the CONTRACTOR. The VARIATION ORDER REQUEST shall contain:

(a) description of the VARIATION to the WORK in question, and
(b) a detailed schedule for the execution of the VARIATION to the WORK showing the required resources and significant milestones, and
(c) the effect on the SUBCONTRACT PRICE with an explanation of how it is calculated, and
(d) a detailed description regarding the effect(s) on the PROJECT SCHEDULE, and
(e) the recovery and/or acceleration measures to avoid, recover or limit a DELAY, and
(f) the impact of the VARIATION on any other parts of the SUBCONTRACT or THIRD PARTIES, and
(g) the latest date upon which the SUBCONTRACTOR shall start with the requested VARIATION to the WORK in order to avoid or minimize any disruption to the WORK and PROJECT SCHEDULE.

10.4 If any of the above items are not considered in the VARIATION ORDER REQUEST, the CONTRACTOR may return the VARIATION ORDER REQUEST for revisions by the SUBCONTRACTOR.

10.5 VARIATION ORDER REQUESTS have to be numbered sequentially by the SUBCONTRACTOR

Article 12—Schedule and Extension of Time

…

12.6 The SUBONTRACTOR may request an extension of time and adjustment of the MILESTONES for reasons not caused by the SUBONTRACTOR.

…

12.8 If the SUBONTRACTOR fails to meet the project milestones specified below and the delay is not attributable to the CONTRACTOR, then the SUBCONTRATCOR shall pay the following liquidated damages to the CONTRACTOR:
… 0.5% of the SUBCONTRACT SUM per week …

12.9 The SUBCONTRACTOR'S liability for delay shall be limited to 12% (twelve per cent) of the SUBCONTRACT SUM.

Attachments to SUBCONTRACT:

1. Scope of Work/Technical Specifications
   Chapter 1—General:
   …
   Chapter 14—Pipe Rack:

The Subcontractor shall perform all necessary detail engineering services and provide all required materials to enforce the existing pipe rack as specified in the Contractors' technical specifications.

The reinforced and extended Pipe Rack must allow for loads of up to 100 tons.

The Pipe Rack shall be installed as specified in the attached drawings …

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7 The Ultra-Long-Distance Energy Transmission Case—The Impact of Contract on a Public-Private Research Network

Carsten Morgenroth

Contents

C. Morgenroth (✉)
Ernst-Abbe-Hochschule Jena, Jena, Germany
e-mail: carsten.morgenroth@eah-jena.de

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Abstract

Two universities and two commercial enterprises engage in a joint endeavor subject to a new line of federal public funding. Viewing X University, transfer manager Melanie McCormack and Head of Legal Department Dr. Stan Benshaw take up the task of creating factual and legal structures for X University's part of the project. In such a public-private project, management needs to work differently: with decision-making bound to the Rule of Law, with additional law that must be considered and with the constitutional right to scientific action working in many directions, processes and internal structures will most likely be very different compared to those found in the private economy. Accordingly, this case study conveys that Contractual Management (CM) tools will only have a limited effect on managing the project for several reasons: CM terminology like Knowledge Management or Management of Transaction can't be fully applied since these activities are widely spread out across university structures; scientists follow other interests than employees and exercise a different freedom in finding and executing their work; and Universities don't primarily pursue commercial, but primarily reputational interests. Yet, certain elements of management, like communication terminology, could be introduced in the contract to bring it closer to serving as the primary tool for steering the project.

Keywords	Research project, public funding, project coordination, intellectual property, limitation of liability
Principle management topic	Enterprise networks
Institution	Public, non-profit
Subject of management	(Business) cooperation
CM process step	Plan, draft
Management field	Knowledge management, risk management
Contract type	Partnership contract

Editor's Note: For a full understanding of the CM Model's practical benefit for the case study, the reader may have to peruse at least Sects. 1.4.4 and 1.4.5 of Part I. The keywords used above to characterize the area of contract application are explained in the key system preceding the case studies in Part II.

7.1 Challenge

7.1.1 Set of Facts

X University is a mid-size public University of Applied Sciences in central Germany. The area has been known for excellence in renewable energies for a long time, so a wide variety of scientific and industrial entities in the field of renewable energies have been established in the area, forming an effective network with a worldwide reputation.

Two regional commercial and two scientific institutions, universities X and Y, all members of the relevant professional network and referred to as "the partners," intend to engage in a joint research project in the field of ultra-long-distance energy conduction. The idea is to help develop new basic research (University Y) with additional applied research (X University) and to transfer this information into model equipment and two specific products: model material of ultra-long-distance conductors (Commercial Partner 1) and a prototype as well as serial product of highly effective transducers (Commercial Partner 2). Since this field is one of the most promising areas of scientific action with foreseeable economic outcome, the German Ministry of Higher Education has promoted similar projects in the past.

The prospective amounts of funding are an estimated total of EUR 1.35 million, divided into EUR 375,000 for Y University, EUR 225,000 for X University, EUR 425,000 for Commercial Partner 1 and the remaining EUR 325,000 for Commercial Partner 2.

In a first meeting, the partners agreed on the project schedule which they divided into five phases. For the initiation of the project, they decided to first implement phases 1 and 2:

- Phase 1: The partners will apply for scientific funding to the German Ministry of Higher Education, which has launched a program dealing with ultra-long-distance energy conduction. Upon application approval, the German Ministry of Higher Education will issue individual Grant Approvals to the project partners.
- Phase 2: The partners will, inter alia, draft and sign an Agreement of Cooperation governing the project as requested in the respective Grant Approvals.

The partners have agreed that X University will identify the funding possibilities, and Y University will draft the Agreement of Cooperation and send it to the project partners for comments and for subsequent negotiations.

7.1.2 Operating Procedure

7.1.2.1 Author's Explanations

Phase 1 leads the partners to the planning of the project. Keeping the focus on X University, let's look over the shoulders of Mrs. Melanie McCormack, Senior Project

Coordinator in the Department of Research Transfer (Transfer) at X University, and observe her at work.

The challenge of Phase 2 in this project is to negotiate the draft of an Agreement of Cooperation (Agreement) for the joint project prepared by Y University. This assignment was given to the Legal Department (Legal) of Y University. Imagine yourself to be Dr. Stan Benshaw, Head of Legal Department at X University, dealing with this draft.

To get a first glimpse of the scope of the entire project in which phases 1 and 2 are embedded, a visual outline of the general procedure of project development as depicted in Fig. 7.1 may be helpful. If we are looking at the first four arrows from the left, Phase 1 is marked by arrows "Cooperation?" and "Application," while Phase 2 includes the Grant

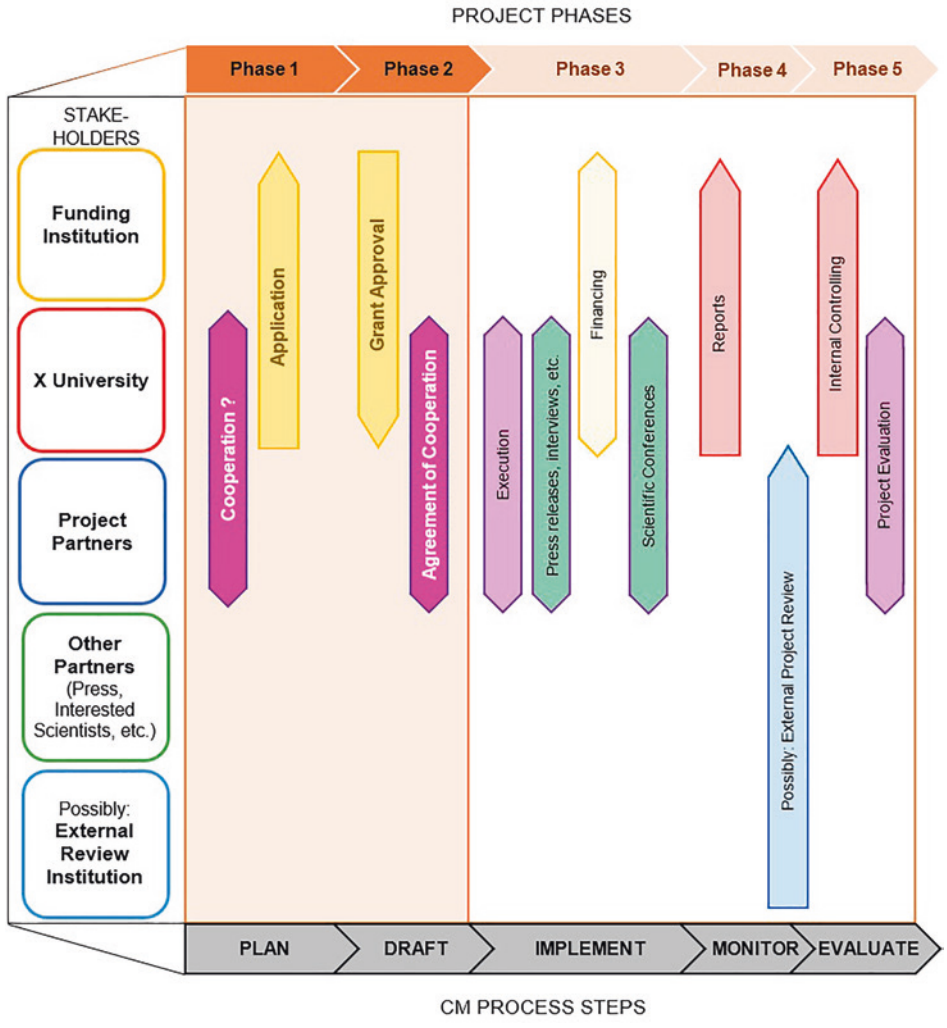

Fig. 7.1 General procedure of research project development

Approval, but is primarily identified by the arrow "Agreement of Cooperation." Still, the arrow "Grant Approval" might contain important legal or management specifications or restrictions, so it cannot be left out. Let's find out how X University brings these four arrows to life.

Since legal and management aspects are involved to an almost equal extent, it might be helpful for the basic understanding of the case to have some fundamental background in both fields. Stressing the particularities of the public sector and a public university in particular will illustrate the greater importance of meeting legal requirements in this case than if there were only private actors involved.

Legal background There are a lot of legal aspects involved in this case. The grants issued by the German Ministry of Higher Education execute the rules of German funding legislation. Grants are administrative acts governed by the German General Administration Act and fall within the realm of public law. The Agreement of Cooperation, however, is a contract concluded between the partners and within the sphere of civil law.

Contract Knowledge: Public Law and Civil Law

Public and Civil Law are essentially different. Although the line dividing these fields of law runs differently according to different jurisdictions, a general orientation can be given:

Public Law outlines the legal relationship between the government and private legal persons like citizens or companies based on state power. In order to be allowed to limit the individual freedoms and rights granted by the German Constitution, every rule of Public Law needs legal justification in the form of a threat of derogating public interests.

In Civil Law, on the other hand, the interacting legal persons are generally viewed to be equal in rights and powers to find agreements exercising their own free will. Only if certain persons are considered structurally inferior, like employees with respect to their employers or private persons in relation to commercially active persons, the freedom of the superior group is limited although still within the realm of private law.

For **further reading** on the difference between public and private law, see [1], pp. 65 et seq. and [2], *sic passim*.

The Agreement of Cooperation that will be concluded between the project partners involves several additional legal aspects, the most important of which are the Law of Intellectual Property concerning the results of the project research, the liability between the partners, and the rules of publication and confidentiality. Furthermore, there are some particularities about doing research at a German University. First, it must be considered that the vast majority of universities in Germany, such as Y University and X University, are institutions under public law functioning under a different legal regime than private actors do.

Explanation: Objectives, Organization and Function of Public Universities

Public universities are entities fulfilling obligations to society such as generating new knowledge through research and integrating it into society through teaching. With respect to these tasks, universities are financially equipped by the Federal Government of Germany or a State Government. Commercial or financial interests are therefore replaced by reputational or institutional interests to a considerable extent.

The first major difference between commercial and governmental institutions is that the latter fulfill governmental obligations. That in itself means several things. The public institution needs a legal statute for performing restrictions of the rights of the respective addressees. All governmental behavior within these statutes is bound by the **Rule of Law** with further implications than just having a regulation, for instance, hearing the addressee before making a decision or fulfilling certain formal standards in procedural actions towards the addressee. In contrast, the commercial sector has a freedom of contractual autonomy which means nearly none of the restrictions listed above apply.

Second, the governmental sector—being different from the commercial system—must obey additional regulations. Good examples may be Public Procurement Law, which puts governmental money under the obligation to be spent on solvent and cost-efficient partners, State Aid Law, obliging the government to calculate projects as if they had to be self-sustained with respect to all project costs including those for personnel (usually part of the governmental payment), or Budget Law, specifying standards for all governmental action with respect to a performance-cost-relation. In contract, the freedom of the private entity owner means he can spend his money pretty much at will.

Third, as a consequence, **internal structures** differ from those in commercial entities. Management departments of all sorts are replaced by structures governing procedures or connecting related areas of work. The non-for-profit work governmental institutions do usually don't give rise to a need for much (financial) management. Even though the model of New Public Management, which originated in Anglo-American and Australian countries, brought German administrative entities closer to structures found in private industries, there is no overall need for structures securing financial benefits. In general, universities still follow the bureaucracy model of Max Weber.

This may be different at universities where enough research projects are being conducted since State Aid Law forces universities to render those projects profitable. As a large university, Y University runs enough research projects to be able to maintain project-related management structures that could be considered similar to those in the private economy. In contrast, X University, as a regionally oriented University of Applied Sciences, does not have enough resources for projects, which means its structures, so far, could not realistically be perceived as "management structures." However, as the numbers of projects and revenue are rising,

X University may well be at the threshold of developing management structures now, so applying the CM Model standards is very interesting for X University.

Also, universities are legally governed by the constitutional **Right of Free Execution of Scientific Work** under Art. 5 par. 3 of the German constitution (*Grundgesetz*). Free execution of science grants a great amount of strategic and procedural autonomy as well as regulatory freedom which means universities can determine their own ordinances. One of the consequences of this autonomy is the absence of power of the university to assign research to scientists.

More precisely, three levels of internal structures are entitled to claim the right to perform unrestricted scientific activities: The university itself, individual departments (such as the Department of Mechanical Engineering or the Department of Medicine) and—of course—the individual researcher and university teacher. It is not uncommon for these participants to claim their rights to scientific action against each other, resulting in internal procedures that need handling and additional structures as well, like the Academic Senate which deals with the academic issues of the whole university or the Department Council which is responsible for academic issues of the respective department. These internal structures and procedures are not seen in other administrative institutions.

The second particularity about university research refers to the fact that professors in public universities are generally public servants, so their status is different from employees. According to the principle of the freedom of research and teaching, researchers in universities cannot be forced to carry out specific research—unlike the employees of commercial partners. Furthermore, there are several decisional boards including the senate as the board in academic questions with primary decisional or veto rights affecting the professional surroundings when working on research. Special information will be handed in at the respective points of procedure.

Management background As seen in the legal background overview supra, internal structures in the public sector, and therefore also in public universities, are different from those found in private business. This is still true, despite the fact that **New Public Management** has hit German public institutions in the 1990s.

Explanation: New Public Management

New Public Management (NPM) is a governance approach that originated in Anglo-American and Australian legal circles in the 1980s. Great demands on public services and on low-cost efficiency in executing them led to a need for more economic methods of work in the public sector. This scenario was embedded in a political era in which the value of social welfare was deemed to be overestimated, especially in Anglo-America, and gave rise to a philosophy of outsourcing public services, deregulating operations and providing services more like the private sector does.

Although primarily designed for municipal entities, NPM was also introduced in other administrative structures such as in universities. Key NPM elements are wider legal and operational autonomy and global budgeting, supplemented by commercial balancing and a new supervisory committee of external experts for universities, which brings strategic structures and everyday work closer to economic standards.

Yet, generally speaking for universities, financial risks exist but are only minimally relevant since the main products a university creates are immaterial. Furthermore, a German public university is held exempt from insolvency by statute, with the consequence that risk considerations, which are predominant in the private economy, are of minor importance and risk management procedures, serving to avoid risks endangering the existence of the company, have not emerged. Also, the NPM approach has not changed the main direction of university work, namely, to serve the common good with quality education and new knowledge, objectives and interests that are institutional and reputational rather than financial. Consequently, the operating structures in German public universities differ considerably from those securing financial existence and prosperity of companies in the private economy.

For **further reading** on public management reform, see [3]; on NPM and university governance, see [4], pp. 137 et seq.

A complex project such as in the present case involves management skills and challenges on several levels for Melanie. First, it requires management structures and resources to find an appropriate line of funding for the project. As senior project coordinator, you can expect Melanie is sufficiently experienced in this. Second, the project needs to be prepared within the realm of action specified in the funding regulations. This may mean Melanie needs to be tiptoeing around the relevant scientific groups, consulting, convincing or even debating with other groups who also want a piece of the cake. Third, the project itself needs to be managed. You can probably see what that means—sharp glasses from being in front of the screen a lot, glowing ears from holding the phone and a lot of travelling money.

But Stan's challenge is nothing short of that. Communication among lawyers may involve, to put it mildly, special vocabulary. That means having all your brain, all your senses and all your heart in every line of mail or paper text to avoid misunderstandings that can cost you months or even the entire project. And what about doing legal research, getting the draft aligned with similar cases in the past, finding the specialty in this particular project and delivering the new regulations in the draft exactly to the point? Furthermore, please consider that Stan—as Head of Legal Department—is not paid to handle only this project. Sweaty forehead, long office hours and squeezing hacky sack balls to release some steam may well be the companions of Stan.

7.1.2.2 Reader's Tasks

The existing set of facts, split into two phases, conveys the tasks at hand.

If you choose to accept Melanie's position in Phase 1, here are your tasks:

Task 1: Identify possible sponsors and relevant lines of funding.
Task 2: Make suggestions for the project structure and coordination.
Task 3: Think about work packages, rights, and responsibilities of the participants.
Task 4: Identify the internal information input required for the application of X University.
Task 5: Prepare the application for X University.

If you are willing to be Stan in Phase 2, you have the following tasks:

Task 6: Explain the need for effective communication between Transfer (Melanie) and Legal (Stan)
Task 7: Think of the design of the Agreement and the basic requirements it must meet.
Task 8: Outline the communication responsibilities of the partners.
Task 9: Think of contractual instruments that can foster cooperation.
Task 10: Delineate how the Agreement should deal with performance risk.
Task 11: Think of a way most appropriate for Stan to initiate modifications in the draft.

7.2 Tasks Melanie (Project Phase 1)

Melanie, acting on behalf of X University, has three main tasks: First, she has to seek out possible financing institutions and deduct the requirements for obtaining such grants; second, she must develop the basic framework of the research cooperation; and third, she will prepare the application of X University to obtain such grants.

7.2.1 Decision-Making Process

Let's try to find answers for the tasks arising in Project Phase 1.

7.2.1.1 Identification of Decisions to be Made and Evaluation of the Decision-Making Circumstances

The goal in Phase 1 is to submit an individual funding application as part of a concerted action of four players. This overall objective is broken down in detail as indicated under Sect. 7.1.2.2.

Task 1: Identify possible sponsors and relevant lines of funding.
As everywhere in life, the most brilliant idea is worthless without bringing it to life. Even in science this may mean money, often in the form of **external funding**. So, Melanie first needs to determine if the project idea could be financially covered by internal resources or if the idea requires additional external funding.

In the latter case, Melanie must reach out for information. The CM Model's structures call the input unit "**Knowledge Management**," whereas an overall University Knowledge Management is unknown as a term as well as a concept and widely spread over several departments, including Legal, Human Resources, Research Transfer (Transfer), Finance and Library, the latter comprising X University's IP unit.

Melanie uses internal sources, such as similar past projects, and external data, including internet searches, databases, or hooking up into her professional network of colleagues to inquire about first approaches or opportunities.

In this project, Melanie could use both internal and external sources of information. From network meetings she learned about the new line of funding "Guiding Technical Excellence 2030" including research on renewable energies to be set up by the German Ministry of Higher Education in order to provide funding for projects like this. Melanie found the specific guidelines and regulations for the new line of funding on the webpages of the Ministry. The **provisions of the line of funding** do not differ much from those installed in various fields of research. The main elements include

- putting the funds under the condition of governmental availability;
- imposing strict regulations on frequent reporting (using forms required by the funder on a bimonthly basis, especially with respect to payments and other financial obligations);
- requiring modification of procurement regimes to the more liberal end to minimize administrative resources;
- imposing standards on the research partners as to scientific and commercial quality and financial stability;
- requiring individual applications for each participating institution for the respective funding amount;
- demanding submission of a negotiated **draft of the project Agreement of Cooperation** between the partners to be submitted no later than three months after receiving approval of the application for funding and of the signed Agreement of Cooperation no later than three months after the start of the project.
- Special to this new line of funding is the requirement of individual **Letters of Intent** by all potential partners prior to submitting applications. These Letters of Intent are based on questions by the German Ministry of Higher Education to secure financial stability in order to prevent exclusion from or interchanging of partners during the project execution due to financial difficulties. Once all of these Letters of Intent have been approved, each potential partner will submit individual applications.

Melanie could also find an internal contract template used for similar cases of cooperation but does not need to in this project since Y University will prepare the draft.

Melanie's approach and considerations are of no legal importance. Following ordinary standards of drafting contracts, they would not be included in the contract. Although the CM Model is designed to make the contract the key element of managing projects, therefore bringing aspects of management into the contract, this does not mean that every step in the process needs to be or will be included. Since Melanie's measures are basic preparatory research, even under the umbrella of the CM Model there is no real need to specify them in the contract.

On the other hand, as you can probably imagine, the funding regulations are of the highest legal importance. Therefore, they will be greatly respected by Melanie and Stan along the way. However, this is nothing particular to the CM Model structures, but rather is common in all publicly funded research projects. Funding regulations are core elements of project management and contracting, no witchcraft at work here.

Task 2: Make suggestions for the project structure and coordination.
How could a project like this best be framed? Would it be useful to have more than one partner work on it simultaneously? Or is it more effective and efficient to **have a consecutive line** of one after the other project milestones? Well, let's have a closer look. Since the funding line includes both basic and applied research, we can assume that there is not sufficient background knowledge for new product lines. Society needs to start from scratch. Since product development is not possible without proper understanding, and applied research needs to build on fundamental research, it is logical to arrange both in a consecutive line of work. Whether they need short overlapping periods or not will be subject to detailed planning. On the other hand, new conductor material and new transducers, the tasks of the two commercial partners, don't seem to be interdependent at first sight. Thus, it is a safe working hypothesis for Melanie to have these parts of the project run concurrently. That means both universities can safely be expected to work on individual and consecutive work packages. The two commercial partners, however, will work simultaneously on their individual challenges.

With all elements of the project in individual care of one partner and with the main project outcome neatly put in milestones and reports, Melanie feels there is no need for extra communication structures such as a **project coordinator or even a steering committee**. Her fellow transfer managers or even the scientists will be able to handle the timely shipping of the reports by themselves. This way the project will not be too expensive and will possibly make the funder more inclined to fully approve the applications.

The funding regulations do not refer to specific legal questions pertaining to the character and structure of the project. Whether or not the partners form a company, which standard of **liability among the partners** will be agreed on, and which partner will be given power of representation of the other partners is to be decided during the drafting of the Agreement of Cooperation and will depend on the negotiations of the partners. Thus, a considerable part of the project planning will be done by Stan while preparing

for the Agreement of Cooperation. This has proved workable since Melanie and Stan have established a best practice process that Melanie will hand over all information in that regard to Stan, and Stan will deal with it.

Task 3: Think about work packages, rights, and responsibilities of the participants.
Melanie will **discuss her thoughts with the scientists**, but since the structure just outlined above is the only reasonable and efficient approach, there won't be a long debate over it. In projects with comparable consecutive work, like doing research in the same field, there might be some haggling over work packages and reports. This is not the case here. There is only one expert in the project for everything, and the work is easily split among the four partners.

Also, scientists tend to give the monetary side of the project outcome too little attention. So, Melanie has to keep in mind what this working structure means for the financial benefit of the project results. Melanie and Stan, over the years, have found a common level of understanding and cooperation with regard to the issues of who works with what intensity on what questions. This includes the mutual understanding that Stan will take care of these questions himself.

Yet, Melanie might be able to set up specific timely dimensions for X University's work package—in cooperation with the scientists who will suggest reasonable milestones. Also, Melanie needs to collect this information from the other participants so the work package of X University can be displayed as part of a whole.

Task 4: Identify the internal information input required for the application of X University.
After identifying the dimensions of the project, Melanie wants to get it ready for the application. For that, she first needs to clarify with the scientific staff how long it will take X University to handle the work package. After that she will include all other departments at X University that will possibly be involved. Maybe they have questions or something to add to the application; Maybe they just need to be alerted and ready for rapid processing when the approval returns.

Departments with possible impact on the project are Legal, Human Resources, Finance and IP Office.

- Besides on the IP protection of the working outcome, **Legal** will advise Melanie on special reporting requirements in the funding regulations, procurement regulation modifications or special stipulations about the use of name and logo of funder on all public project communications.
- **Finance** will give information about necessary additional funding acquisition, and enable Stan to fill in the legal structures accordingly. Finance will also take charge of the financial transaction details and documentation and inform Melanie about unusual specifics.
- **Human Resources** will check the funding regulations on exceptions to travelling costs, sick leave payments or the handling of temporary transfer of staff.

When everything has been determined and clarified, all Melanie needs to check is the internal signature and postage provisions so she can include the right people at the right time and in the right order for singing and shipping.

7.2.1.2 Making the Decision

After collecting all relevant information by means of conversations with scientists, colleagues and other members of administrative staff- what might be considered Knowledge Management—and examining it in detail, Melanie will have a clear picture of the financing of the research, the cooperation of the partners and the work share of X University. Accordingly, the applications will be sent

- to the German Ministry of Higher Education,
- under the line of funding "Guiding Technical Excellence 2030,"
- by each of the four partners individually,
- for the agreed work packages, and
- following the concerted working schedule.

Additional input may be acquired and will be fed in. May be there has been a discussion on the structure of project coordination with her fellow transfer managers that need to be decided for X University? Maybe there was some debate about the details of reporting? Is there potential for misunderstandings in the passages created by the scientific group in the sense that project managers are used to a different vocabulary than scientists and might not grasp the same meaning? Melanie has to sort out these things first before being able to draft an application.

Based on these findings, Melanie can instruct Stan for Phase 2 and initiate the application procedures for X University.

7.2.2 Implementation of the Decision

The **external implementation** of Melanie's decisions lies in the creation of the application of X University based on the tasks and the filtering named above and in taking the necessary procedures.

Prior to finishing the application, however, Melanie will shortly discuss the dimensions of the required **Letter of Intent** (LOI) with Stan and, based on internal LOI forms, adapt it to this individual project. Creating the application will take time which can be used to wait for the approval of the LOIs in compliance with the funding requirements.

Task 5: Prepare the application for X University.
Now it's time to put it all on paper and get the application on its way. Melanie will take the scientific part of the application and include it in the **forms** supplied by the funding institution. The application forms usually have a volume of ten to fifteen pages. When

filled in, they might grow up to 40 pages easily, mainly depending on the intensity of detail of the scientific part. With respect to administrative matters, however, only in very special cases, like for specific questions regarding financial stability, will Melanie check with her colleagues on the specific wording or phrasing of **certain parts of the application**. In general, Melanie determines the specifics, including general descriptions of the university and their overall scientific and teaching quality, and will make decisions about the phrasing herself.

Before sending it off, it might be useful to **coordinate with the other partners** about the time of postage so that the entire application will be received by the funding institution in a timely manner. An important documentation like this application might be handled in **secure and traceable postage,** preferably by personal certified delivery.

Internally, Melanie must communicate her decisions regarding the application to several departments that will be involved when the Grant Approval arrives so that they will be ready to begin immediately. So, Melanie wisely alerts Legal, Finance, the group of scientists and the Presidential Board, maybe also the University Research Commission and Human Resources, of the departure of the application, maybe in connection with estimated timelines for review and response.

7.3 Tasks Stan (Project Phase 2)

As a quick reminder: the assignment Stan faces is to adapt a draft for an Agreement of Cooperation outlined by Y University's legal experts to the needs of X University. Possible requests for modification of the draft will be negotiated subsequently and jointly with the other project partners as outlined under Sect. 7.3.2.

7.3.1 Decision-Making Process

Not surprisingly, the main elements governing the decision-making process for Stan in Phase 2 seem to be of a contractual nature. However, whereas the Agreement obviously is addressing manifold legal topics, many of its regulations are related to management issues under the guise of law since they are dealt with in the contract. This holds particularly true for extra-legal risks such as e.g. quality risks, which are dealt with by the contract's warranty clauses and, therefore, are frequently addressed as contract risks or legal risks. Tracking and defining the issues to be covered by the Agreement is a challenge that may require a little experience as the governing fields of law are scattered across both German and European law.

Yet, the potential of using the Agreement as a means of quality management is there, not only for outlining the communication process and streamlining the organization of the joint endeavors but also for opportunities that will help make the project run more smoothly.

7.3.1.1 Identification of Decisions to be Made and Evaluation of the Decision-Making Circumstances

Task 6: Explain the need for effective communication between Transfer (Melanie) and Legal (Stan).

One of the headline slogans in Toyota's advertising strategy was "communication is everything." At this point in the process, this is imperative and essential. Stan needs to communicate with Melanie for several reasons.

First, he must learn all about the project. Any detail can be of crucial importance or just of good use for the contract. Crucial would be whether the university research team is free to roam the field of science or if they are bound by IP rights such as patents known to other potential partners. Good to know would probably be whether all competent market participants are involved in the project. If so, it might be useful to think about excluding any clause governing the exchange of partners. Stan will find out all of that in his contact with Melanie prior to sending off the application.

Second, there might be some differences in understanding specific terminology between non-lawyer Melanie and lawyer Stan. For instance, what is an "invention," a "legal interest" or a "breach of contract" in Melanie's eyes? Did she have a correct perception of these terms while collecting the facts of the project so that Stan may accept them? Or does he need to translate the term from its general to a legal perception? It is always useful for both to be in personal contact for such details.

Third, understanding the project dimensions first and applying the law later has proven to fit the open approach of science better than immediately filtering the project through the lens of risk as commercial partners tend to do. Of course, risks must be evaluated carefully and thoroughly and will not be overlooked, as seen above pertaining to IP rights. But universities are much less subject to damage claims than commercial enterprises might be. Of the several reasons that could be named for that, the two most convincing may be the fact that universities are—sometimes and especially in this new field—the only experts in their respective fields and the respect for science in business more generally.

7.3.1.2 Preparation of the Decision

Task 7: Think of the design of the Agreement and the basic requirements it must meet.

After understanding the dimensions of the project, Stan will identify all relevant legal aspects to see if the draft transferred by Y University refers to them in a way acceptable for X University. Furthermore, Stan will check if useful or necessary management instruments have found their place in the contract. Working under CM Model structures, this may mean including more management elements than before and safeguarding that the legal solutions suggested are workable from a management point of view.

7.3.1.2.1 General Considerations

Contract templates may be a blessing or a curse at this point in the project. The positive side is that they save time to stipulate details. They may also help you think of things. But having a valid template for a certain project structure can make it very tempting to carelessly look over the questions at hand, believing the template contains all the details this individual project needs, which is nearly never the case. Stan is usually freed from this task when accepting someone else's drafts. However, it may happen occasionally that the partners assigned with the drafting call Stan for help out of his own basket. With a thoroughly experienced institution like Y University, this is highly unlikely and did not happen in this case.

Another aspect Stan needs to consider is the **preamble**, which is located somewhere between the law and the facts.

Contract Knowledge: Preamble

A Preamble (or Recitals) is designed as a means to enable interpretation in times of disputed understanding of clauses and usually contains the factual background as well as the leading motivations and interests of the partners. It is not part of the contractual regulations but explains the background of the party interaction.

For **further reading**, see [5], pp. 66–67 and [6], pp. 89 et seq.

A preamble created by another university will most likely include all aspects important to Stan, especially the particularities of the public sector, in which not so much commercial but rather institutional, reputational and society's interests matter. Yet, Stan would be well advised to look carefully if the aspects of applied sciences which X University stands for—such as transfer of knowledge into production—has been included sufficiently.

Stan must also check that the **Agreement is self-explanatory** in legal terms so that its management potential is made available. Not only lawyers are involved in the handling of the Agreement, and it will be scientists first and foremost who will have to deal with the Agreement and therefore need to understand its wording. More importantly for CM Model purposes, the top management signing the Agreement will accept it as the central project management tool if it explains itself in the right way. Therefore, it should be in an easy-to-read format and understandable even to non-lawyers.

A **list of definitions** of the most important terms may be necessary to secure the required level of legal understanding. But it may also be beneficial to include management terms in the definition list as well. Not all drafts contain lists of definitions, though, so Stan will have to be on his partners' case to get at least the most crucial definitions, such as background, side ground or foreground implemented. The terms background, side ground and foreground have been introduced by the European Commission with respect to governing research as part of the European Market and mark all aspects of

the relevant project outcome, depending on its origin: background describes past projects, side ground pertains to projects running concurrently to the reference project, foreground means the project outcome of the reference project. If the terms to be defined can be easily agreed upon as in the given case, where there are valid definitions out with Y University's draft, it will take some time and effort but will very likely not be debated much. Other elements may be harder to get added to the draft. As a general rule, it becomes harder with the increasing number of project partners.

7.3.1.2.2 Requirements of the Grant Approval

Management aspects first and foremost consist of reporting, as required by the Grant Approval, and project communication, the latter favorably including decent structures for dispute settlement. A project involving (only) four partners and displaying independent working structures usually does not imply the need for a team of professional communicators. Thus, Stan does not need to fight for more professional communication resources in the upcoming negotiations with his fellow lawyers. Details have been specified under Task 3.

7.3.1.2.3 Risk Issues

There are three legal aspects Stan needs to be aware of: respecting the funding provisions, securing proper project execution, and handling risks and opportunities. Setting mental priorities, Stan will focus on risks first, since they cross over into all other aspects. However, in spite of this primary position, risks are not subject to a structured risk management process in public universities and are approached differently than in private business: institutional risks first, financial risks second.

The uses of the project outcome, intellectual property and liability are the risks with the highest stakes. Especially the first two aspects affect the very rarely occurring risk of partners cancelling or interchanging.

- Before starting the legal machinery of details, Stan needs to be aware of the **project's overall legal structure** in which its outcome will be embedded. Basically, there are two fundamentally different ways to shape a research cooperation: by way of a contract that coordinates the party's contributions through a partnership, e.g. a consortium, or through a contractual joint venture.

Contract Knowledge: Partnership and Contractual Joint Venture

Agreements of Cooperation exist mainly in two shapes, as a Partnership or as a Contractual Joint Venture. Both forms arise out of the freedom of private legal subjects to create and stipulate contracts.

A **Partnership** is constituted as soon as more than one legal subject agree upon pursuing a common purpose. Since following the path of a research and development project like this here is a common purpose, it is highly likely the Agreement

will be shaped and considered a partnership in the legal sense. This affects internal and external aspects. Internally, the partners will execute the project according to its purpose, resulting in joint usage rights with respect to the project results and limited liability towards one another in the case of damage caused to a partner. Externally, third persons alleging or claiming damages may hold each project partner responsible, which includes research partners like X University for product damages or commercial partners responsible for potential IP infringement by universities.

But there are also disadvantages to a partnership. First, as mentioned above, it renders all partners fully liable to third persons claiming damage, notwithstanding internal claims of regression. Second, in Germany, a partnership is considered its own tax entity subject to its own tax declarations. Given the solid three-digit number of research projects X University conducts each year, its Tax Section of the Department of Finance would urgently need additional resources.

So, it might be wise to stipulate the contract as a **Contractual Joint Venture**. That way the Agreement of Cooperation implements all possible contracts between the partners into one parallel document. All contracts hereunder mean the agreements of all individual partners towards all partners they intentionally have legal contact with in executing the project. For instance, Y University, doing basic research, may or may not have intentional contact to the two commercial partners. In the latter version, there may not be a need for regulations governing execution but merely covering risks. That way the parties would be subjected to one contract but without forming a partnership and thus avoid the disadvantages of a partnership.

Yet, the parallel structure formed in a Contractual Joint Venture shelters several obstacles as well. First, it is hard to read as a compilation of several contracts. Second, construction of those individual contracts in a Contractual Joint Venture may be difficult as the collective stipulations may not always reveal to which specific contractual relationship the passage applies. Third, on the other side of the coin, regulations seemingly valid for all partners but effectively only useful for certain partners may overdo the standard of regulation or be essentially obsolete for most applicable situations. These disadvantages, without empiric data available, tend to steer contract creators towards partnership agreements, despite their considerable obstacles.

For **further reading** on this topic, see [7], marginal notes 113 & 114 and [6], pp. 11 et seq.

In this case, Y University decided to swim in the stream and to draft a partnership agreement.

- The **project outcome**, in projects running mainly consecutively like this one, can be divided into clean slices, yet viewed as a whole as well. Each individual institution will be entitled to the packages of basic research (Y University), applied research (X University) and cable material (commercial partner 1) or transducers (commercial partner 2) which the other partners need for their work. This is why contracts usually grant free rights to use these results for the duration and purpose of the project.
  The two public institutions need to internally deal with the specialty of having public servants as scientific personnel; their project results are legally entitled to them personally, forcing universities to set up internal structures for transferring or licensing project results. In addition, it is not unreasonable to assume that the results of research will find their way into the products to some extent, thus combining the elements of the partners.
- **Intellectual property**, especially inventions resulting in patents or creations in copyrights, is relevant in several ways. First, the Agreement must and usually does include stipulations pertaining to joint patenting and primary transfer between the project partners. Second, IP needs to be handled differently outside the project, even among the partners. IP Law, which is applicable to all partners and, additionally, European State Aid Law for the two universities stipulates the obligation to put IP handling outside the project under ordinary market conditions, usually handled in analogy to licensing. In consequence, the partners, including the public universities Y and X, have to charge the respective partner a license fee. Third, universities X and Y need to find internal regulations for inventions solely originated by professors (internal use transfer) or a group of public servants and employees combined. German Law of Labour Inventions gives the professor ownership of the invention but puts him under the obligation to notify the university. Employees participating in the creation of inventions, however, are subject to mandatory transfer of the right to the invention to the university as their employer as well as to statutory remuneration.
- **Liability** may be handled very liberally within the present research project as German General Terms and Conditions of Business (GTCB) Law restrictions do not apply to legal partnerships. However, the standards set up by the GTCB law are usually a valid point of orientation, leaving liability for personal damages in full force and restricting other internal liability to intent and gross negligence.

Contract Knowledge: Limitation of Liability

As a general rule, legal subjects are liable for any form of intent or negligence under sec. 276 German Civil Code (GCC) for the Law of Contracts and sec. 823 GCC for the Law of Torts. The legal consequences consist of the obligation to restitute the original factual situation or, if impossible, compensate the material, sec. 249 GCC and immaterial, sec. 253 GCC, damage.

However, German Law of Contracts enables contractors to deviate from these rules, restricting liability. Several layers need to be kept distinct here. First, liability for personal injury, death or other personal damages may under no circumstances be restricted. Any limitation of personal damages would be void due to violation of the cogent German law cited above. When dealing with material damage, partnerships are exempt from GTCB application. Therefore, partners are free to regulate their own terms of liability. They can deviate from statutory law by modifying the conditions of liability, e.g. restrict it to intent and gross negligence, or the consequences, for instance through maximization of damages to a certain amount or a percentage of the contract value (so-called cap), or the exclusion of certain types of damage, for instance consequential damages such as loss of profit or interest.

Apart from contractual regulations, there is restricted liability of employees or public servants, limiting liability to intent and some cases of gross negligence as a simplifying first approach. These restrictions follow other legal and political purposes, namely the protection of the structurally inferior group of the workers with respect to their employers.

For **further reading** limitation of liability in R&D contracts, see [8], pp. 260 et seq. and [9], pp. 524 et seq.

Yet, there is an important differentiation to be made between **internal liability among the partners** and liability towards external persons claiming to be damaged. In most projects, the partners form a partnership since more than one legal person follow a common purpose. German Company Law states that external persons may hold the partnership or any of its members legally responsible for damages, even if the damage was not caused by their individual work package (which in itself is a tricky matter in scientific projects, by the way: Who will be able to say that a product malfunction is not at least to one per cent based on incorrect research?). Therefore, Agreements of Cooperation usually include regulations stipulating the internal handling of external damage claims like supporting each other in situations of claims from third parties with information or even legal resources. Especially for the two universities in this project, being legally attacked even for product damage may have an additional cause besides research error—solvency: public institutions like universities are protected from insolvency and this may be attractive for a plaintiff. So, universities must check carefully if the Agreement of Cooperation contains regulations pertaining to internal damage restitution transfer and if they are modified compared to the standard in the GTCB Law.

This is the **primary checklist** Stan is working with. Being an experienced lawyer, he is well aware of the fact that clauses set up in drafts usually tend to benefit their creator, here Y University. This may work in Stan's favor when specialties of the public sector are reflected, but also to his detriment, especially in IP clauses that are highly advantageous for Y University.

Task 8: Outline the communication responsibilities of the partners.
Knowing the risks of the research cooperation should make it much easier for Stan to evaluate the appropriate structure of communication as part of the **Knowledge Management** system. Still, the job needs to be done. This aspect is important to make the project work. In terms of the CM Model, it also holds the most potential to make the 'management element' communication part of the legal structure 'CM-based contract.' A well thought out and executed communication network in the contract will likely persuade the top-level management of the respective entity to build management of projects around the contract.

The first task here is to determine the **overall communication structure**. Who is in charge of communicating what when to whom? The advantage in this procedure is to establish responsibilities for both ordinary and deviating performances. Since the latter aspect is one of the core legal risks, the contract is likely to be more persuasive to top-level management when the stipulation of the communication structure in the contract is directly connected to avoiding this risk. Therefore, it may be good advice to start regulations on communication in the contract with: "In any event of performing the contract, the parties agree to abide by the following structure of communication: …" or, even more concise: "The parties agree to abide by the following structure of communication: … This structure is binding especially in the event of a deviation of contract performance."

In determining **individual communication responsibilities**, the question arises whether the respective information will be assigned to the scientific or administrative staff. As always, of the three possible groups of information, the one in the middle—which is here listed at the end—is the most challenging.

- Distributing new formulas, calculations, technical drafts or prototypes among the partners is clearly scientific information and should therefore be handled within the group of the scientists involved. It must be considered here that such information in many cases will be confidential or even business secret and the participants not willing or not allowed to disclose it. Therefore, it is crucial that the Agreement provides for explicit rules regarding which information must be disclosed under which conditions.
- Storing the contract and all relevant attachments, acquiring governmental funding payments, issuing invoices or sending required reports to the funding institution is beyond doubt administrative work—the administrative staff is competent in these procedures.
- But who needs to be informed about delays in the project performance, in the reception of funds or in the arrival of international partners for project purposes, like speakers for a conference or guest scientists for collaborative work? Should both groups of involved persons always receive this information so that nothing gets lost? Or is it enough if they inform each other on a regular basis, the frequency of which is to be determined in the Agreement?

In big projects—like this one—following the thread of thoughts outlined above, it may even be useful or imperative to install **professional communicators** as a separate sub-structure of the project. In this case, Stan can work with Melanie's measures from the planning phase. Such sub-structure should be planned, and adequate resources applied for, otherwise it needs to be equipped with X University's own financial resources. However, Stan "only" needs to refer to it in the contract; but remember: the more details the contract holds regarding any kind of communication to legal risks, the more likely management will accept it in the contract bringing it closer to the CM Model structure. This is true for this sub-structure as well.

In order to solidify the legal risk approach, it is very important to determine and regulate how much and which kind of **documentation** the project communication needs. Especially when the project is on the line, partners need proof of what happened. There is a very fine line between securing risks and working effectively with an emphasis on scientific work (that is why the project exists, after all). It takes a bit of experience and a lot of internal communication to find out how much documentation the internal project participants deem appropriate and, if their idea does not match the legal minimum, to swiftly persuade them.

Task 9: Think of contractual instruments that can foster cooperation.
Aside from containing (legal) risks, the contract also opens up the path for many opportunities. German Contract Law follows the doctrine of private autonomy (sec. 311 GCC) which establishes a wide realm of freedom to shape contracts, the most important being the freedom to engage in a contract at all, to choose the partner(s), the time, the duration and—essentially—the content of the contract. In line with this, partners of a contract may deviate from the GCC and other codifications of German Civil Law as long as this deviation stays within the corridor of cogent civil law (i.e. cogent law forbids the minimization of liability for personal damages or the total exclusion of liability for other damages). Stan will therefore check the draft presented by Y University for elements limiting opportunities as well. Besides liability restrictions, the most essential opportunity in research projects may be governing the modification of working packages through extra communication, the requirement for consent or other elements.

There are other potential advantages a contract may bring to the project besides stipulating communication within the project.

- First, naturally, Stan may think of including communication outside the project as well, establishing a clause stating or indicating **friendly, supportive or at least non-detrimental communication** of the partners during the project or even beyond.
- Second, an element widely used in contracts to emphasize the **mutual trust** of the partners in their substantial quality and institutional integrity is the preamble. Mutual trust fosters relationships from the past or enables them for the future. As stated above, the preamble is designed to outline the factual background and the motivations and interests of the partners involved to assure a correct interpretation of any vague

terms in the contract. In addition to this legal purpose, however, the preamble may introduce positive moral, ethical or even personal aspects into the contract that will likely be very beneficial for all partners involved in the future and therefore are subject to keen interest of solid management.

- The third potential is a little bit ambiguous and needs careful handling. Being free to leave the path of the law, parties may seek advantages that may not necessarily be for the good of other partners. Which advantage of mine will conclude in what detriment to which partner? What will a suggestion in this direction mean for everything said before? Naturally, depending on the negotiating power and on the importance of the given endeavor, Stan (and all his colleagues) will choose his wishes and pick his fights very wisely. For instance, it has been a good strategy for years at X University to release most of the submitted invention declarations back to the inventor, mainly for financial reasons. Agreements of Cooperation, however, in most cases contain a clause that the partners "will have all inventions registered" and have subsequent clauses dealing with procedures and costs. Depending on the individual position of X University during negotiations, Stan needs to weigh opportunities and risks: Is it wise to have this clause ruled exempt for X University, causing instability in the transfer chain? Or would it be feasible to have the inventions in this very project registered in order to keep other imperative elements in the Agreement? Stan will have a statement ready from Melanie or will have to get back to the scientific group if the question arises during negotiations.
- An enormous opportunity to avoid costly and lengthy disputes in the judicial sector is to implement individual or alternative **dispute resolution structures**. However, the specific structure needs to be chosen wisely, for different settlement structures vary and may turn out to take longer and become more expensive than taking the case to court.
- **Professional coordinators** like a steering committee or staff having no other obligation than communicating data within the project may be, according to the individual project, a necessary tool or a great simplifier. For this project, refraining from establishing a separate team for communication purposes is as wise as it is reasonable.

Task 10: Delineate how the Agreement should deal with performance risk.
In a research network, each partner depends on the contributions of the other partners. Thus, the **performance risk** is of crucial importance to the success of the project. The Agreement, therefore, not only has to delineate the work packages, timelines and communication obligations of the partners, but also must put regulations in place for the case that one of the partners fails to fulfill its obligation. With respect to X University, the main concern has to be Y University falling out of the picture since X University depends on their results. Guiding this performance risk means enabling the project to interchange basic research institutions.

Especially the later situation highlights the key requirement of Stan's process of thinking: a non-legal element, being a factual failure of below-the-line-performance,

triggers legal necessities like contractual risk management. As Germany belongs to the Civil Law family, its legal system is based on comprehensive statute books providing regulations which deal with performance issues. Since most of them pertain to non-mandatory law, Stan will have to modify such regulations according to the interests at stake.

How does German statutory law deal with performance issues?

- First, German Law is basically divided into Civil Law, Public Law and Criminal Law. A contract between public institutions, such as universities, on the one hand and private entities on the other hand is necessarily a contract ruled by Civil Law which in Germany displays a considerable amount of flexibility (freedom of contract). However, a **contract according to Public Law** is only possible when all partners are part of, or equipped with, public authority; such contracts are governed by mandatory law to a large extent. So, the cheat sheet a student may look for in the given case is to be found in German Civil Law. The general regulations on breach of contracts are sec. 280 et seq. GCC.
- Second, sec. 280 et seq. GCC contains three major variations **how to breach a contract**: no performance (impossibility), late performance (delay) or performance below the quality standards agreed upon (underperformance). The main reason for impossibility to occur here is probably the failure of public funding. Considering the project timeline Stan has received from Melanie, he will certainly see the risk of impossibility right from the start but needs to remind himself that funding may cease to flow during the project as well.
- Third, the structure of breaching variations named above needs to be enhanced a little bit further. German Contract Law differentiates between **material and minor breaches**, sec. 280 GCC. Generally speaking, a material breach is one that affects the so-called essentials of a contract, usually consisting of the main substantial obligation and the payment obligation. So, problems in communication obligations such as reporting usually do not mark a material breach. This may be different in two situations: the reporting affects the funding or other payments, or the project partners agree upon defining these mistakes as material breaches. The consequence is a higher or lower amount of compensation, so the commercial partners in particular may express an interest in bringing minor problems all the way up to the pedestal of material breaches.
- Fourth, to bring the legal skeleton to an end, we know one last structural spilt that is of importance: sec. 281 par. 1 sent. 3 GCC states that one party may **refuse full performance** if the other party performs only in part and if that performed part is of no interest to that party, the latter determined in a legal sense. In project structures where all partners work independently of each other, a substantial underperformance by one partner does not affect the other partners and will therefore not turn into a legal risk. But in chain-structured projects where partner B depends on the full performance of partner A in order to be able to execute its own tasks, this risk may occur and needs to be dealt with.

Even though there are comprehensive and detailed regulations on how the contractual parties may deal with performance issues, the question arises to which extent such **provisions are operational**, and in particular, whether they are enforceable in court.

Let's start with the—somewhat less complex—second question. Agreements of Cooperation are fully eligible to judicial review and subject to civil procedure. However, reaching into the first aspect as well, planning research, to a certain extent, is like a psychic playing the glass ball of the future or the famous "box of chocolate" Forrest Gump's mother referred to. Sometimes, you'll never know what you're going to get, and sometimes research will just lead to nowhere. In that sense, a legal title is worthless if the facts fail to follow.

Contract Knowledge: Performance Requirements of Public Research Contracts
Research agreements concluded by public universities are always designed in such a way that the **"best effort in exercising expert skills"** is sufficient, and there is no obligation to achieve a specific result.

Yet, there are **other standards** to be considered that mark the method of research more than its result. In exercising research procedures, attentive readers will stumble across such phrases as "scientific care" or "current technical standards" in nearly every Agreement regulating research projects, whereas the "current scientific standard" will be found only in very specific projects. This is easily explained when considering the meaning of these standards:

- "Current technical standards" obliges the researcher to implement everything into their work that is technically known and practically working.
- "Scientific care" refers to special requirements to exercise measures, derivations or documentations of information meticulously and conscientiously, including standards of scientific ethical codes.
- The "current standard of science," on the other hand, includes everything that has been written on a certain topic in a scientifically approached manner. Thus, such very high standards are only necessary in projects involving very specific risks, e.g. when pertaining to nuclear energy or lifesaving in general; apart from that it may only be useful in some basic research projects in which new scientific areas are explored.

See for example the Agreement on research cooperation of the Federal Ministry for Economic Affairs and Energy [10], in particular sec. 3.1 and 16.1.

The first aspect of securing the project holds two dimensions. Besides the possibility of restrictions by judicial review there is a—highly likely—chance that the funds will cease to flow if the milestone reports fail to display sufficient progress, putting the project itself

at risk. New staff is employed that may need to be laid off, new equipment is acquired that needs maintenance etc. Usually Grant Act and contract address these risks by generous lines of action saving as much of the project as possible. After all, it's good money, and tax money, too, that otherwise would be buried for good.

7.3.1.3 Making the Decision

Stan had to review the actual draft sent over by Y University for the project and to decide which issues needed further negotiation. The draft already addressed the main questions such as project milestones, reporting, joint handling of working outcome and IP as well as the important risk issues mentioned above. It also displayed a smart cascade of liabilities: full damage control in personal injuries, restriction of liability to intent and gross negligence and waiver of liability in all other cases.

Interchanging partners throughout the project, on the other hand, was not a topic Y University included. Stan sensed that there was no need for it, because in new fields like ultra-long-distance energy conduction there might only be one player out on a market who is able to perform.

The execution of the project will tend to be on the less complicated side as all partners work individually and separately. There is no risk of parallel work and co-dependency in sight. Clean and timely reporting, i.e. communication, will wrap up the dimensions of carrying out the project to a great extent. Yet, usage rights of results for those partners in charge need to be addressed and secured.

7.3.2 Implementation of the Decision

Task 11: Think of a way most appropriate for Stan to initiate modifications in the draft.

Negotiating a draft is a bit like going to court. A lot of it is based on experience and psychology. Will Stan negotiate individually, or will he bring in all partners to one meeting, video or telephone conference? Who will he call first in cases of individual consultation? Or will he wait for Y Universities' activities, maybe for reasons of not interfering with certain roles (with Y University writing the draft, the ball may be in their hands to initiate negotiations)?

Stan is well advised to consult his top-level management beforehand to find out about red lines and his overall leeway in the negotiations. According to the 2007 Thuringian Act of Higher Education, the Presidential Board is considered a structure of science management rather than administration of science, leaning on commercial blueprints as a consequence of the New Public Management approach for governmental work. It should not be overlooked that a university sends out signals of quality management if a result needs to be revoked for reasons of rejection by top-levels.

In the project at hand, Stan has to deal with two local respectively regional lawyers and one central legal department in Hamburg handling one of the commercial partners. Instead

of a conference, he may favor individual negotiations, since he knows the Hamburg team to be rather adamant about their positions and wants to feel them out first. Since Y University is over the top with other projects, Stan sees good chances to reach a concession agreement with Hamburg that he can live with and is convinced that he can persuade the other two colleagues fairly easy with the argument he has "Hamburg on board."

7.3.3 Process Optimization

It is always a hinderance for legal not to be in the loop for receiving a copy of the Grant Approval. This makes it very hard to be helpful on time. Stan has sent several complaints to the Presidential Board on this topic, but so far there has been no change in the communication structure. Stan feels it can't be hard to think of another mail copy to Legal with the Grant Approval attached, so there is room for enhancing structures at X University. Grant Approvals are imperative for preventive planning of contracts. Not only do they regulate non-legal elements like project communication (reporting etc.), but sometimes they also modify procurement law with the effect that goods need to be procured under the Grant Approval regulations rather than according to the law. The wrong procurement procedure may result (and had resulted) in financial sanctions. Other elements of the project may also be defined or modified by the Grant Approvals, endangering the flow of funding resources in cases of violation.

Five years ago, a new internal guideline has been introduced at X University, governing structures, operations and requirements for commercial research projects. An evaluation of this guideline is imminent. A combined analysis of the results of two evaluations, the one pertaining to commercial research under the guideline and the other to publicly funded research as done here, could lift strategic knowledge inside X University to a level which would make it possible to derive the necessary steps for implementing CM or at least near-CM-structures for governing research at X University.

7.3.4 Actual Execution

The actual execution fell short of the benchmark processing in several ways.

First, the preparatory contact between Melanie and Stan was very rough due to Melanie's long periods of **sickness**. No one else in her team was able to produce nearly as much information as she could. So Stan needed to periodically check and doublecheck on team transfer at X University.

Second, with X University being the junior partner of the project, Stan's legal leeway was limited, complicating negotiations. Stan needed to watch his back with Y University Legal as well as with the commercial alliance. Y University was adamant about being **included in all X University patents** since they felt their fundamental research results were automatically linked to, and included in, applied research results of X University.

Stan needed to take a detour to the scientists so they could set up possible substantial distinctions. Finally, Y University Legal was convinced that individual patenting was possible for X University as well. The legal departments of the commercial partners were not ready to grant X University the ten per cent of the **after-tax profit** that Stan demanded. Stan argued that X University had a double impact on the commercial products: research results and communicative support in scientific conferences, publications and the like. But the commercial alliance did not give in until Stan produced a regulation of State Budget Law stating public assets need to be commercialized at full market prize. That seemed to convince the commercial alliance and diminished their negotiating potential.

Third, the final version of the draft produced by Y University did not match the results of legal negotiations on one crucial point. The omission of certain **liability restrictions** was claimed to be an accident according to the notification of Y University Legal. But considering the process of the negotiations, Stan had serious doubts whether Y University Legal struck out the passage without intentionally doing so. At first sight, crossing out liability of the universities for malfunction of the product is an advantage for X University, too. But Stan felt committed to transparent communication and good faith action, meaning he wanted to stick to the results reached during the negotiations. Certainly split-faced, but determined to ethical standards and timely restrictions, Stan needed to point out that the omission diverged from negotiation conclusions.

7.4 Learning Outcome

7.4.1 CM Value for the Case Study

Determining the value of the CM Model for the case study leaves an ambiguous impression.

On one hand, most of the elements of the CM Model itself could not be applied to the university research project. The structures and sub-structures of the CM Model do not match with those at the university in a way that allows for a simple application of their meaning and function. Terms and concepts like Management of Transaction, Risk Management or Knowledge Management need to be translated into, and assigned to, the existing structures of the departments Legal, Human Resources, Finance or Transfer, those in part being subdivided further, e.g. for commercial and public projects. The CM Model elements, as seen, are scattered all over the university, reaching into academic and central administration. Therefore, CM, as it appears in this book, needs some adaptation to be fully applied to university contexts. First, definitions need to be reviewed in their CM meaning and in the necessary adaptation for universities as the latter remain public institutions with specific requirements. Second, individual tasks of the respective CM management processes may be assigned to existing departments. This, third, may create merged or split departments or even new workflows. But all this must be reflected against the purpose of university work: as a public institution, at least in publicly funded projects like this, the university

must ultimately serve the public. After that, the Presidential Board will be able to decide whether or not university research projects may be governed by the contract through CM.

On the other hand, the case study has shown on several levels that a contract may be considered a useful, or even the most useful, element of project management. This means that universities may well think about adapting their project processes to CM structures, given the CM Model itself is adapted to university environments. Elements like the preamble, seen from a management perspective, the list of term definitions, enhanced by management terms or the concise depiction of communication structures with direct connection to legal risks are means to bring management to and in the contract and to make the contract the steering wheel of the project, especially for the management level. So, after the definitory and structural homework outlined above has been done, universities may well implement CM as their main management tool in research projects.

7.4.2 Case Study Value for the Reader

Asking the author about the value of his deed to the victim is a bit like asking the cook if his meal is tasty. Of course, I believe the lines I have produced are the ultimate way to put this project into the purpose of this book. And, as always, readers will see—if any—other values. So, let me just point out some dimensions in the most objective way possible that may give you an indication of where I see potential for value for the reader.

First, this paper points out every little step in the long chain of thought process for cooperation projects at universities, from sketch to handshake. Thus, this paper is a reader's guide and the first available on this specific subject. There is no **comparable instruction or orientation available** in the relevant literature. This may satisfy the procedural learning interests of readers.

Second, the study addresses the management and the legal levels and tries its best to have legal material embedded into the respective management areas. Thus, readers and prospective managers can find the necessary legal background of the working structures they are familiar with. I hope readers are inclined to understand that the law is not an enemy, but a helpful friend, and the **law does not need to dominate a manager's** work but in many cases just translates management decisions into legal terms even if put in a legal document such as a contract.

Third (or maybe second a.), students of management come across the necessary legal knowledge along the way. This may feed the interest in the law.

Fourth, CM Model structures could not be and were not applied in their verbatim sense and meaning. Instead, they had to be adapted to structures that exist within a publicly governed entity like a university. A reader may come to the conclusion that the CM Model is a means to serve a purpose (managing projects through contracts) and not a purpose in and of itself. Modifying, adapting and enhancing is first nature of these means. Readers, when in charge themselves, may feel invited to undertake this changing endeavor.

Fifth, for the first time, specific fields of law and management (preamble, list of definitions, communication) were brought together as possible CM Model elements in a contract. This hopefully gives readers a concrete grasp as well as detailed insight about how the CM Model can be utilized for university projects.

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The Oil Platform Case—Managing Conflicts in a Consortium Relationship

8

Ulrich Hagel

Contents

U. Hagel (✉)
Bombardier Transportation, Berlin, Germany
e-mail: ulrich.hagel@de.transport.bombardier.com

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Abstract

This case study deals with the warranty case of a Customer under a contract concluded with a consortium consisting of two consortium members. The consortium members have entered into a second contract amongst themselves, the Consortium Contract. In the given situation of delay, the consortium members have to consider both contracts to make an informed decision on how to react. They have to evaluate the consequences of the different options to identify the preferred solution. This entails complex processes: With respect to organization and communication, a considerable number of fields of management as well as a variety of departments and management functions are to be involved; With respect to content, decisions will be made in an interaction of explicit legal rules and implicit social norms. The processes, however, are dominated by risk management considerations. Thus, when deciding whether to start arbitration, the claiming consortium partner performed a Litigation Risk analysis leading to a rational and transparent selection of the Best Alternative to a Negotiated Agreement (BATNA).

Keywords	Consortium, joint and several liability, defects liability, BATNA, decision tree, Litigation Risk Analysis
Principle management topic	Conflict management
Institution	Large company, private, profit
Subject of management	Relationship, enterprise
CM process step	Implement, evaluate
Management field	Risk management, knowledge management, claim management
Contract type	Consortium agreement

Editor's Note: For a full understanding of the CM Model's practical benefit for the case study, the reader may have to peruse at least sect. 1.4.4 and 1.4.5 of Part I. The keywords used above to characterize the area of contract application are explained in the key system preceding the case studies in Part II.

8.1 Challenge

8.1.1 Set of Facts

Chilli Petrol Ltd. (Customer or C) operates 40 oil platforms around the globe and is headquartered in Bergen, Norway. Atlas Oil Engineering GmbH (A) and Buliburton SA (B) are competitors in plant engineering and plant manufacturing. Both are designing and manufacturing—amongst others—oil platforms. The Customer has entered into a contract for the delivery of 25 oil platforms (Customer Contract) with a consortium (Consortium) consisting of company A and company B (Consortium Partners or Consortium Members). According to the scope of work split between A and B, both parties are responsible for designing different parts of the platform (e.g. A being responsible for the design of the accommodation container, B being responsible for the design of the

drilling equipment). However, when the platforms are designed, both companies manufacture complete platforms. A is responsible for manufacturing and delivering 15 platforms and B is responsible for manufacturing and delivering 10 platforms.

In order to perform the scope of work under the Customer Contract, A and B have entered into a partnership agreement in the form of a consortium (Consortium Contract).

Contract Knowledge: Consortium and Consortium Contract

A consortium consists of two or more companies that work together toward achieving a chosen objective. Each entity within the consortium is only responsible for its designated scope of work under the consortium contract. Therefore, every entity that makes up part of the consortium remains independent in his or her normal business operations and has no say over another member's operations that are not related to the consortium.

Usually, the consortium is led by one of the consortium members, called the **consortium leader**. The duties of the Consortium Leader are solely of an administrative and coordinative character, including:

- Technical, commercial and organizational coordination of the consortium members in the bidding phase and during contract execution;
- Acting as the spokesman in negotiations with the customer, authorities or any third parties which are of joint interest, including preparing the necessary correspondence;
- Submitting the bid for the consortium and coordinating necessary formalities, in particular regarding a potential mandatory registration of the consortium, keeping the necessary books, and, preparing and submitting tax returns for the Consortium; convening, presiding and keeping records of the meetings of the executive body(ies) of the consortium;
- Making proposals for joint insurance coverage for all the consortium members;
- Coordinating the establishment of a joint construction site;
- Coordinating the preparation of progress reports and other documentation to be submitted to the customer;
- Collecting data for invoicing the customer and collecting payments from the customer; and
- Performing any other duties assigned to the consortium leader by the consortium agreement or through a respective resolution or decision of the consortium members.

Within the Consortium Agreement, the partners usually cover the **external relationship** of the consortium as well as the individual partners towards the customer and the **internal relationship** amongst the partners.

For the typical **structure and content** of a consortium agreement see Appendices (Structure of a Consortium Agreement).

As members of the Consortium, A and B have a joint and several liability towards C under the Customer Contract (external relationship), Customer C can either claim the group of the consortium members for performance or payment (joint liability) or, at its choice, any individual (either A or B) (several liability).

Contract Knowledge: Joint and Several Liability
Under joint and several liability, the liability for default is enforceable against all of the signatories as a group, or against any one of them up to the full amount of the Customer's claim as an individual at the choice of the enforcing party.

Regarding the internal relationship of the consortium partners, the Consortium Contract stipulates:

- Each party is responsible and liable for its scope of work. The party having delivered the respective platform will rectify all defects on such platform; the costs of rectification, however, shall be borne by the party being responsible for the defect, i.e. having caused the defect.
- The "liability for damages" between the consortium partners is limited to EUR 1 million per event.
- Disputes between the consortium partners shall ultimately be settled by three arbitrators under the Rules of Arbitration of the International Chamber of Commerce.

By way of the consortium leader, the Customer notified the Consortium of a defect of the accommodation containers of the platforms 25 months after delivery by the Consortium.

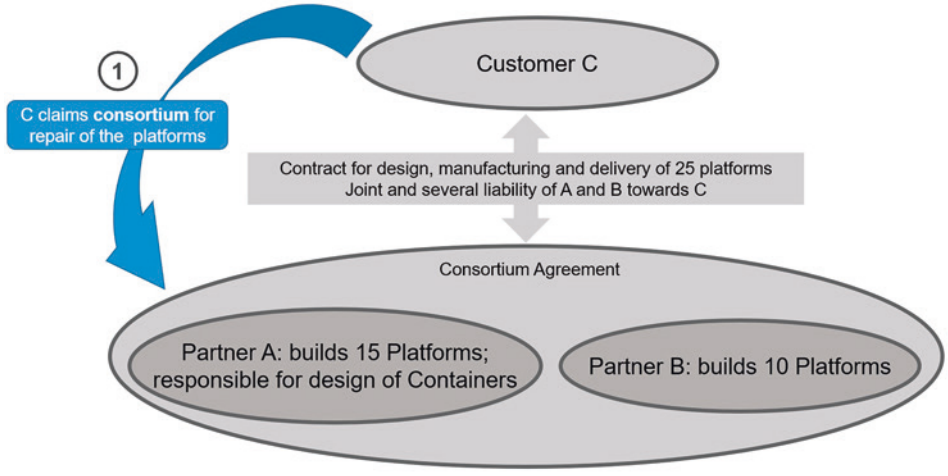

Fig. 8.1 Customer's claim against the consortium

Table 8.1 Consortium partner's arguments and B's evaluation

Argument of A	Argument of B	Evaluation of B
Defect caused by the Customer C when cleaning the accommodation container	Water should not have hit the wooden floor which is covered by linoleum	80% chance to win the argument that there is a defect
If a defect: no design defect but caused by bad workmanship	Water ingress caused by wrong design of the interface between wall and floor	80% chance to win the argument that the defect is a design defect rather than a workmanship defect
Limitation of liability "for damages" also includes rectification work	Limitation of liability does not apply for rectification work	60% chances to win the argument that the limitation does not apply
C's claim would be time-barred	No, as time-barrage has been suspended by negotiations with C	70% chance to win the argument that C's claim is not time-barred

According to the Customer, the wooden floor of the containers, which is below the linoleum coverage, is rotten due to water ingress. He is claiming for the rectification of the defect. A design of the claim situation is displayed in Fig. 8.1 above.

When the consortium partners address the issue, Company A, being responsible for the design of the container, refuses to repair its 15 platforms. Company B is willing to perform the rectification work due to legal considerations, all the more because the market expects C to place further contracts on oil platforms soon. In the subsequent discussion, the partners exchange arguments for their positions as outlined in Table 8.1 above.

The project manager of Company B (Project Manager) now considers B's options to proceed. Table 8.1 above also displays the Project manager's evaluation of the chances to win the respective argument.

8.1.2 Operating Procedure

8.1.2.1 Author's Explanations

The case at hand deals with a conflict between two consortium partners concerning an obligation to rectify a defect in the Consortium's work. Consequently, it relates to two contracts: the Customer Contract concerning the duty to rectify; and the Consortium Contract when it comes to the issue of which of the consortium partners is under this obligation and to which extent. Both contracts, one relating to a transaction, one to a business cooperation, are in the implementation phase (**CM process step implement**). The decision-making processes will thus be influenced by the contractual provisions of the two contracts.

All the decisions to be made under Tasks 1. to 3. (see below under Sect. 8.1.2.2) are strongly related to **risk management** as they have a direct impact on the profitability of the project. They are also impacted by strategic considerations of company B and thus by corporate management. The contracts in this situation work as a source of risk as well as a risk management device.

The Project Manager must decide how to deal with certain situations. To make an informed and conscious decision, he has to identify the factual and legal decision-making circumstances and evaluate their relevance for the case at hand (**knowledge management**). Both contracts are crucial sources of information.

8.1.2.2 Reader's Tasks

You are the Project Manager of B. Process the tasks listed hereunder based on the contract clauses, Table 8.2 below.

Task 1: Decide whether B wants to rectify the defects notified by C on (i) the 10 platforms of B or (ii) on all 25 platforms or (iii) not at all. (Level of difficulty: Medium)

Task 2: Assuming B has repaired all 25 platforms: Assess whether to claim against A for compensation of the incurred repair costs of EUR 5 million. (Level of difficulty: Low)

Task 3: Assuming B has claimed against A: After tough negotiations, A is making a final offer ("take it or leave it") to pay B an amount of EUR 1.2 million to finally settle B's claim. Would you accept A's proposal based on your evaluation of the arguments raised by A during the negotiation? (Level of difficulty: High)

Table 8.2 Tabular listing of argument probability

Argument of A	Argument of B	Evaluation of B
Defect caused by the Customer C when cleaning the accommodation container	Water should not have hit the wooden floor which is covered by linoleum	80% chance to win the argument that there is a defect
If a defect: no design defect but caused by bad workmanship	Water ingress caused by wrong design of the interface between wall and floor	80% chance to win the argument that the defect is a design defect rather than a workmanship defect
Limitation of "liability for damages" also refers to rectification work	Limitation of liability does not apply for rectification work	60% chances to win the argument that the limitation does not apply
C's claim would be time-barred since warranty period is two years	No, due to state law time-barrage has been suspended by negotiations with C	70% chance to win the argument that C's claim is not time-barred

8.2 Decision-Making Process

8.2.1 Identification of the Decision to be Made and Evaluation of the Decision-Making Circumstances

Re Task 1: Decision whether to repair the containers and if yes on how many platforms. Fig. 8.2 below

The consortium consisting of A and B is facing a claim from C to repair the floor of the accommodation container on all 25 oil platforms. A has already decided on how to react and has rejected C's claim. B now has several options:

(a) Not to react at all ("wait and see");
(b) Join A in rejecting C's claim;
(c) Repair B's own 10 platform;
(d) Repair all 25 platforms.

As B is a private company with the business purpose of generating profit, decisions to be made are based on whether they make commercial sense. Any decision to repair the platforms will have an immediate negative impact on cost, profit and cash. So, naturally there is a tendency to decide against doing the repair (as A did). However, when making such a decision, B must first evaluate the case at hand and thereafter the advantages, disadvantages and potential consequences (immediate, mid-term and long-term) of all the alternatives. In evaluating the case at hand, B will analyze whether C is entitled to the repair of the accommodation containers. Such entitlement can either be based on the

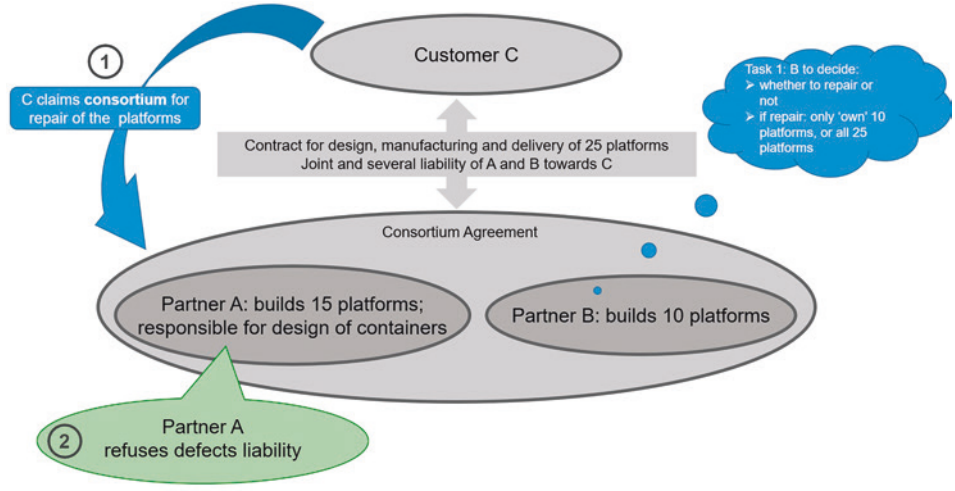

Fig. 8.2 B's decision whether to repair

contract or the underlying applicable law. As C is claiming for the repair of an alleged defect, the concept of defects liability needs to be verified by B.

Contract Knowledge: Defects Liability (Warranty)
Defects liability means all liabilities and obligations arising out of or relating to the repair, rework, replacement or return of defective Goods or Services ('Business Products'), or any claim for breach of warranty with respect to any Business Products.

Besides the legal evaluation whether C, assuming the accommodation containers are defective, is entitled to claim rectification (repair) or only damages and whether such a claim might be time-barred, B will need to do a technical evaluation whether there is a defect under the legal definition and if yes, what kind of defect (design, material, workmanship). B will further have to analyze the contract as well as the applicable law with respect to the defects liability obligations. Based on this evaluation, B will also have to consider the overall business relationship with C as well as with the consortium partner A. In addition, B will have to consider the reputational consequences with respect to all other business relationships by creating a precedence.

Re Task 2: Assess whether to claim against A for compensation of the incurred repair costs of EUR 5 million. Fig. 8.3 below
Assuming that B has decided to repair all 25 platforms and incurred costs amounting to EUR 5 million, B needs to decide whether to back-charge those costs to the consortium

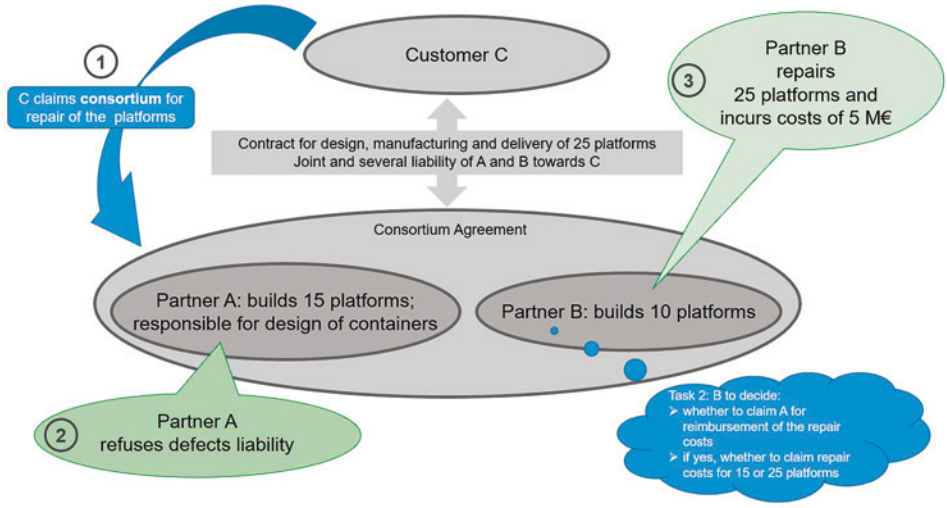

Fig. 8.3 Customer's claim against the consortium: B's decision whether to claim compensation

partner A. As A has already rejected option of repairing the containers, B cannot count on any goodwill from A and would thus only decide to file a claim against A based on a contractual/legal entitlement. B will also need to decide whether to back-charge the full amount for all 25 platforms (EUR 5 million) or only for the 15 platforms built by A as A has failed to repair its platforms (EUR 3 million).

Re Task 3: Should B accept A's proposal to settle its claim for EUR 1.2 million? Fig. 8.4 below

Now that B has repaired the platforms, incurred costs of EUR 5 million and has decided to claim cost compensation in the full amount of EUR 5 million from A, the parties must enter into settlement negotiations. A offers to settle the claim of B for EUR 1.2 million. B must decide whether A's settlement proposal in the amount of EUR 1.2 million should be accepted and the claim be closed. This is a primarily commercial decision. B will have to first look at the alternatives to accepting the settlement proposal. Unless B has a commercially better alternative (BATNA) than settling for EUR 1.2 million, B will decide to pursue this opportunity.

Contract Knowledge: BATNA

BATNA stands for **B**est **A**lternative **t**o a **N**egotiated **A**greement, which is the most advantageous alternative course of action a party can take if negotiations fail and an agreement cannot be reached.

For **further reading,** see [8].

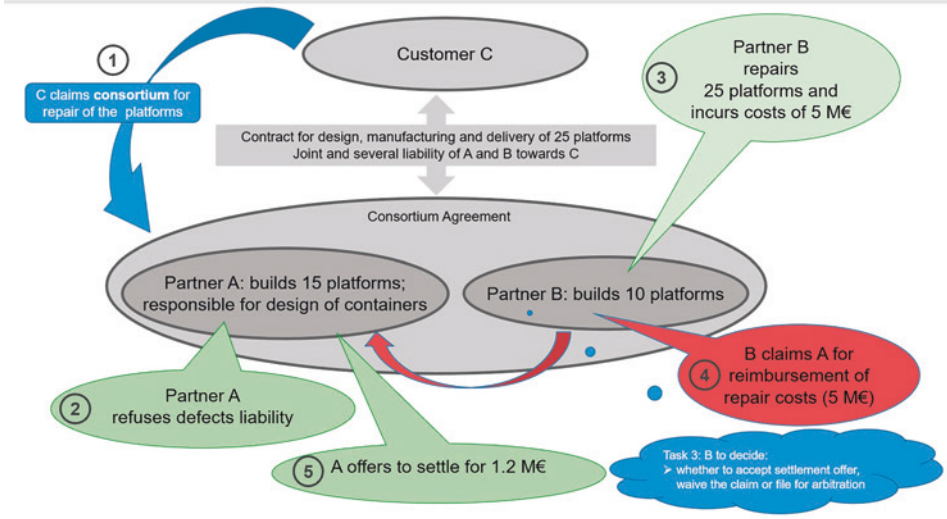

Fig. 8.4 B's decision whether to accept A's settlement offer

Without A's contribution, B has the following alternatives:

(a) Accept the settlement proposal;
(b) Waive its claim against A;
(c) File for arbitration to let the arbitration tribunal decide on the claim.

Obviously, option (b) is not a better alternative to accepting the settlement and will thus not be chosen by B. In order to decide whether option (c) is more favorable than accepting the settlement proposal, B will need a detailed evaluation of the expected outcome of the arbitration as well as the investment costs to achieve such an outcome.

8.2.2 Preparation of the Decision

In order to prepare for the tasks described above in Sect. 8.2.1 and to perform the respective evaluation, the Project Manager will **need the following information**:

Re Task 1: Decision whether to repair the containers and if yes on how many platforms.

(a) Information on the facts to determine the root cause of the rotten floors of the accommodation containers.
(b) The Contract between the Consortium and the Customer on the delivery of the oil platforms. Such information is needed to evaluate whether the Consortium is obliged to rectify the oil platforms and, whether any claim from C against the Consortium or any member of the Consortium (due to the joint and several liability) would be time-barred.
(c) Provisions on Defects Liability as well as time-barrage under the law applicable to the Contract with Customer C. Such information is needed to verify to what extent contractual provisions apply or the provisions of the underlying applicable law and whether the law is mandatory or dispositive.
(d) Information on Customer C, especially with respect to (potential) new business. This is needed to see whether the decision can only be based on a legal evaluation or whether further aspects need to be considered.

Re Task 2: Assess whether to claim against A for compensation of the incurred repair costs of EUR 5 million.

(a) The Consortium Contract in order to determine the responsibility and liability of the consortium members and thus of the partner A as well as any potential limitation of liability.
(b) The documentation of costs incurred for the repair of the 25 platforms to evaluate the available evidence supporting B's argument on the quantum of the claim.

(c) The documentation of negotiations with C to reject A's argument of time-barrage.
(d) A list of (potential) witnesses regarding costs incurred, defect (including technical expert opinion) and negotiations with Customer C to (i) support the settlement negotiations with consortium partner A, and (ii) be prepared for an arbitration should the settlement negotiations fail.

Re Task 3: Should B accept A's proposal to settle its claim for EUR 1.2 million?
(a) An evaluation of probabilities to win its arguments to evaluate the value of its claim;
(b) The investment costs to run legal proceedings.

Tasks 1–3 relate to **knowledge management** and **risk management** as all decisions need to consider the alternative scenarios and balance the chances and risks associated with it.

The **decision process** is a sequence of steps. The decision for task 1, for instance, requires the following steps: gather information (see above) ->define/re-evaluate the options at hand ->list pros and cons and further consequences of each option ->run analysis and determine the preferred option ->identify potential roadblocks for such option ->check whether such road-blocks can be eliminated/mitigated (if not, choose a different option) ->take an informed decision and implement such decision

8.2.3 Making the Decision

Re Task 1: Decision whether to repair the containers and if yes on how many platforms.
(a) **Pros and cons** for possible repair work: Table 8.1 above delineates the advantages and disadvantages of each of B's decision options relating to the possible repair work which have been outlined under Table 8.3 below. B will make its decision on the basis of this analysis.
B's decision whether to repair the platforms or whether to join A in rejecting the repair is not solely to be determined on contractual/legal ground. Business relationship and upcoming business needs to be considered by B as well.
(b) **Decision**: Taking into consideration the potential liability of the Consortium towards C, the likelihood of a design defect caused by A, the fact of a joint and several liability of the consortium members towards C and potential upcoming business with C, B may decide to repair all 25 platform as requested by C.

Re Task 2: Assess whether to claim against A for compensation of the incurred repair costs of EUR 5 million.
(a) **Analysis**: Usually, claims are placed with a maximum plausible position ("MPP"), not to lose credibility but to anchor as much as possible.

Table 8.3 Pros and cons for B's decision options whether to repair

Option	Advantages (pros)	Disadvantages (cons)	Potential consequences
No reaction	No immediate action required No costs and cash-out	Customer will be disappointed and may claim rectification	Chance: Customer will not pursue the claim any further Risk: 1. Customer takes legal action which will cause costs on top of repair costs 2. Customer repairs the platforms/gets the platforms repaired by third party and claims for cost compensation. Such cost is likely higher than B's cost
Join A in rejecting claim	Alignment with consortium partner	Customer will be disappointed and may claim rectification	Chance: Customer will not pursue the claim any further Risk: 1. Customer takes legal action which will cause costs on top of repair costs 2. Customer repairs the platforms/gets the platforms repaired by third party and claims for cost compensation. Such cost is likely higher than B's cost
Repair own 10 platforms	Risk of not getting compensated by A will be reduced	Unhappy Customer can still claim for repair of the remaining 15 platforms	Chance: Customer will not pursue the claim on the remaining 15 platforms any further Risk: 1. Customer takes legal action related to the 15 unrepaired platforms which will cause costs on top of repair costs 2. Customer repairs the 15 platforms/gets the 15 platforms repaired by third party and claims for cost compensation; such cost is likely higher than B's cost
Repair all 25 platforms	Happy Customer	Risk that A will not compensate for the costs incurred	Chance: Customer will notice difference in behavior of competitors A and B and will take this into account in future projects
Option	Advantages (pros)	Disadvantages (cons)	Potential consequences

Explanation: Anchoring
Anchoring is a cognitive bias that describes the common tendency to use the first piece of information offered (the 'anchor') as a reference when making decisions. Once an anchor is set, other judgments are made by adjusting away from that anchor, and there is a bias toward interpreting other information around the anchor. For example, the initial amount claimed sets the standard for the rest of the negotiations, so that any settlement lower than the initial claim amount seem more reasonable even if they are still higher than the real claim value.

For **further reading**, see [1], Chap. 11.

B has incurred costs of EUR 5 million which is documented and can be proven. B can further build a line of argumentation justifying the right to full compensation of B's costs by A. Thus, B has a plausible position.

(b) **Decision**: As claiming against A is the commercially preferential solution, B will decide to place a claim against A. Since B has a plausible line of argumentation, B will claim cost compensation in the amount of EUR 5 million from A.

Re Task 3: Should B accept A's proposal to settle its claim for EUR 1.2 million?

(a) **Litigation Risk Analysis**: As A has made a final settlement proposal, B needs to evaluate whether accepting such a settlement proposal is better than pursuing arbitration under the consortium agreement.
In order to evaluate the chances of its claim, B can perform a Litigation Risk Analysis based on a Decision Tree, which will be described step by step.

Step 1: Building up the tree
The Decision Tree must be built specifically for the dispute at hand. To do so, all issues relevant to the outcome need to be identified. Such issues form the 'nodes' of the tree where the arbitrators will have to make a decision. The order of the decision nodes needs to ensure that all relevant aspects are considered before the end of a branch.
Unless there are nodes where one of the possible answers leads to a direct result (usually a dismissal), the decision tree starts with the main fact-based issue (e.g. defect, delay or infringement), followed by some legal pre-conditions, and ending with the quantum. In the example at hand, B's claim will not be successful if it turns out there is no defect at all and the rotten floor was caused by Customer C. B's claim will also be dismissed if C's claim was time-barred since, in this case, B repaired the platforms without a legal obligation and thus B will not be able to back-charge A. However, if there is a defect, the question whether it is a design defect is relevant and, only in the case that there is a liability, the question of a limitation of liability needs to be answered. In consequence, the decision tree for the case at hand looks as shown in Fig. 8.5.

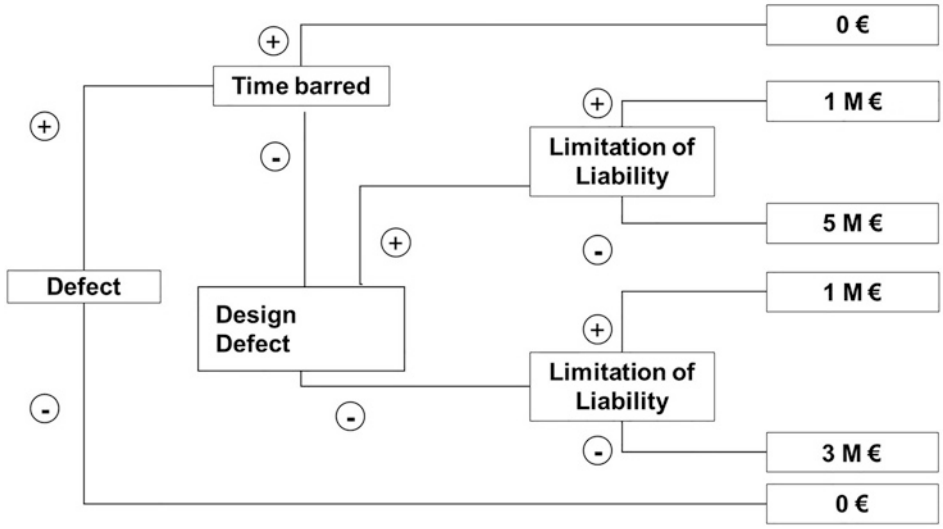

Fig. 8.5 Decision tree without probabilities

Even though there is a defect in **scenario 1**, a judge would dismiss the claim if it is time-barred. In this case, the outcome ("scenario value") for B would be EUR 0.
In **scenario 2**, there is a defect, the claim is not time-barred, the defect is a design defect and the limitation of liability kicks in. In such a case, the scenario value (i.e. potential award) is EUR 1 million.
The best case for B is **scenario 3**, in which there is a defect and it is a design defect, the claim is not time-barred and the limitation of liability is not applicable. In this case, the scenario value for B is EUR 5 million.
In **scenarios 4 and 5**, Customer C's claim is not time barred and there is a defect. However, it is not a design defect but a workmanship defect with the consequence that each consortium partner is responsible for the containers it produced (A: 15 containers, corresponding to repair costs of EUR 3 million; and B: 10 containers, corresponding to repair costs of EUR 10 million.). In scenario 4, the limitation of A's liability applies, whereas in scenario 5, it does not. The scenario value of scenario 4 is EUR 1 million and the scenario value of scenario 5 is EUR 3 million.
The worst case for B (besides scenario 1) is **scenario 6**, in which there is not even a defect. The scenario value is EUR 0.
This first step of building the Decision Tree provides a comprehensive overview of the nodes to be decided by a judge/arbitrator as well as the respective results. As can be seen, the potential awards of an arbitration tribunal can be EUR 0, EUR 1 million, EUR 3 million or even EUR 5 million.

B's evaluation of the own arguments
80% chance to win the argument that there is a defect
80% chance to win the argument that the defect is a design defect rather than a workmanship defect
60% chances to win the argument that the limitation does not apply
70% chance to win the argument that claim of C is not time-barred

Fig. 8.6 B's evaluation of the own arguments

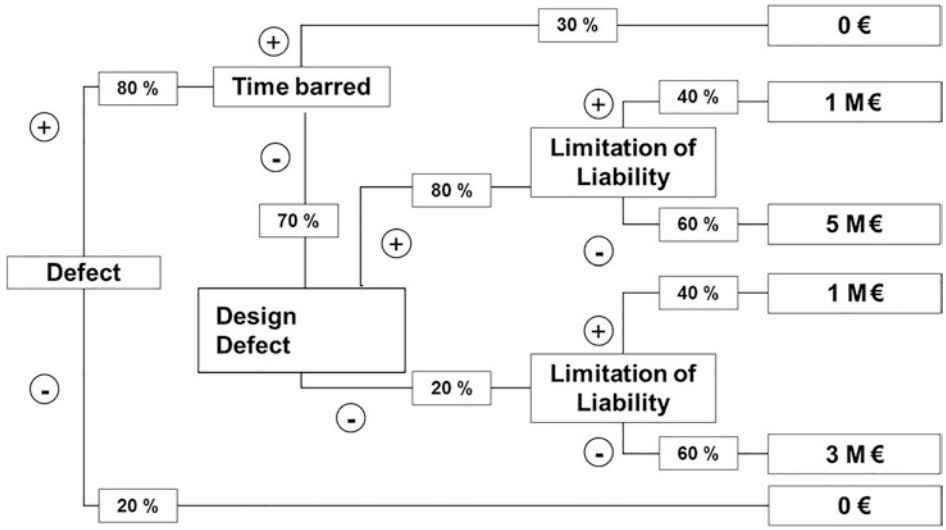

Fig. 8.7 Decision tree with probabilities

Step 2: Adding probabilities
The second step is the most difficult part as percentages need to be identified at each scenario branch, representing the probability that a court or arbitration tribunal will follow the respective argument. As per the task, B evaluates the chances to win its arguments as depicted in Fig. 8.6 above.
Inserting the respective probabilities into the decision tree would lead to the decision tree shown in Fig. 8.7 above.
For each node, the probabilities need to add up to 100%. (Node 1 "Defect": yes ("+") 80% + no ("−") 20% = 100%).

Step 3: Running the calculation
The next step is pure mathematics. The probability of each claim scenario will be calculated by multiplying the individual probabilities comprising that claim scenario. In the example, for claim scenario 1 (defect yes but claim time-barred), the

Claim Scenario	Individual Probability				Compound Probability	Scenario Value	Scenario Expected Value
1	80%	30%			24.00%	0 €	0 €
2	80%	70%	80%	40%	17.92%	1,000,000 €	179,200 €
3	80%	70%	80%	60%	26.88%	5,000,000 €	1,344,000 €
4	80%	70%	20%	40%	4.48%	1,000,000 €	44,800 €
5	80%	70%	20%	60%	6.72%	3,000,000 €	201,600 €
6	20%				20.00%	0 €	0 €
					100%	Expected Value of Claim	1,769,600 €

Fig. 8.8 Claim scenarios and calculation of the expected value

compound probability equals 24% because the first outcome (defect) was assessed with 80% and the second outcome (time-barred) with 30% (80% × 30% = 24%). In other words, there is a 24% chance of claim scenario 1 occurring.

Similarly, the compound probability of claim scenario 2 is: 80% x 70% x 80% x 40% = 17.92%. The overview of all scenarios is shown in Fig. 8.8 above:

With the compound probabilities of the claim scenarios, the expected values of the scenarios can be calculated by multiplying the compound probability with the scenario value. In the example Fig. 8.7 above, the likelihood that a court awards EUR 5 million (scenario 3) is 26.88%, thus the expected value of such scenario is EUR 1.344 million (26.88% × EUR 5 million). In order to get the expected value of the claim in total, the expected values of all claim scenarios need to be added up. In the example, the expected value of the claim is EUR 1.769 million (see Fig. 8.8 above). The expected value will not be awarded by any court as only EUR 0, EUR 1 million, EUR 3 million, or EUR 5 million can be awarded, but it is an average value of a simulation of 100 awards on the specific case. It considers the uncertainties and the different probabilities.

Step 4: Considering the investment costs

The Project Manager has to decide whether to pursue a claim in a formal dispute resolution process, or whether to enter into a negotiated settlement. For such decision, the expected value of the claim, as determined above, is not sufficient. The Project Manager needs to consider the costs to be invested in a formal proceeding as well as a potential reimbursement of such costs by the opponent (to the extent B wins the proceedings). The cash-flow of all such costs is a further aspect, the Project Manager should take into consideration. In order to get a decision by the arbitration tribunal (award), B needs to file a request for arbitration against A. This will cause costs on both sides. In order to file the request for arbitration as well as to run the arbitration proceedings, B will hire external lawyers. A will also be represented by external lawyers, which B might have to compensate A for in the case that B looses the arbitration. In addition, the administration fees of the arbitration institute need to be paid as well as the arbitrators. The parties (A and B) will incur their own further costs (transactional costs as well as opportunity costs).

In the example, ICC arbitration has been chosen. With an amount in dispute of EUR 5 million and 3 arbitrators, the administration fee is EUR 45,015, the fees for the arbitrators are in the range of EUR 98,000 to EUR 425,700, which would lead to a worst case scenario of EUR 0.470 million (EUR 45,000 + EUR 425,700). Since the ICC cost calculator works with US Dollars, for simplification, an exchange rate of 1:1 is assumed. Based on the German Lawyers Compensation Act (RVG), each of the external lawyers can charge EUR 41,260. Assuming the arbitration will have two rounds of written statements with 3 months each, a further 3 months for preparing evidence (witnesses and experts) and 2 months for hearings and post hearing briefs, each party will incur internal costs of EUR 264,000. The internal costs are calculated based on the assumption that the claim team, consisting of members of different functions, will spend 200 h/month for 11 (not consecutive) months at an hourly rate of EUR 120 (see for further details [2] and Fig. 8.9 below). According to Art. 38 (4) ICC Rules, "the final award shall fix the costs of the arbitration and decide which of the parties shall bear them or in what proportion they shall be borne by the parties." Art. 38 (5) ICC Rules states: "In making decisions as to costs, the arbitral tribunal may take into account such circumstances as it considers relevant, including the extent to which each party has conducted the arbitration in an expeditious and cost-effective manner." [3] In the worst case, this means that all costs (administration, arbitrators and external lawyers; further relevant costs are not considered in the example, e.g. experts, reimbursable costs of the parties, such as in-house counsel costs.) are to be borne by the losing party.

Further investment costs may need to be considered, depending on the specific circumstances. They may include opportunity costs, interests, further transactional costs and costs of taking evidence. As these investment costs vary significantly, they are not included in the calculated example.

Considering the investment costs for the arbitration minus the reimbursable costs in each claim scenario will lead to different expected arbitration values. If B wins the full claim amount of EUR 5 million as well as the cost award, the internal costs of EUR 264,000 are still not reimbursable and need to be deducted from the scenario value reflecting the net result of the award. In the calculation displayed in Fig. 8.10 below,

Type of Costs	Amount based on a claim amount of 5,000,000 EUR	Advances	Reimbursable	Worst-Case
Administration Costs	ICC: 45,015 USD Arbitrator Min. 98,301 USD Arbitrator Max. 425,700 USD	A and B share 370,000 USD	yes	470,715 EUR
Lawyers	41,260 EUR	A and B	yes	82,520 EUR
Transactional Costs	264,000 EUR	A and B	no	264,000 EUR
Total				**817,235 EUR**

Fig. 8.9 Investment costs and cash-flow for arbitration

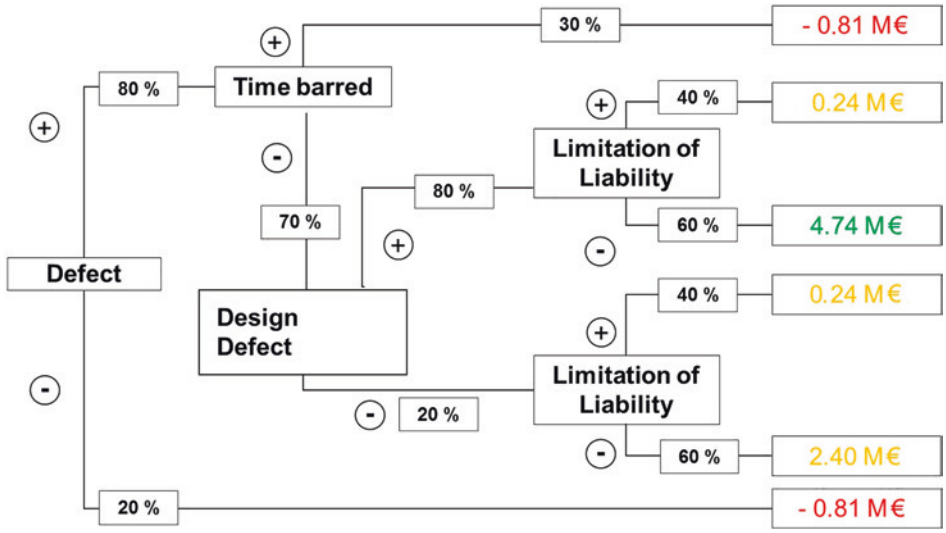

Fig. 8.10 Decision tree with probabilities including investment costs

Claim Scenario	Individual Probability				Compound Probability	Scenario Value	Scenario Expected Value
1	80%	30%			24.00%	-810,000 €	-194,400 €
2	80%	70%	80%	40%	17.92%	240,000 €	43,008 €
3	80%	70%	80%	60%	26.88%	4.740,000 €	1,274,112 €
4	80%	70%	20%	40%	4.48%	240,000 €	10,752 €
5	80%	70%	20%	60%	6.72%	2.400,000 €	161,280 €
6	20%				20.00%	-810,000 €	-162,000 €
					100%	Expected Value of Claim	1,132,752 €

Fig. 8.11 Claim scenarios and calculation of the expected value including investment costs

the cost allocation follows the ratio of win/loose. The decision tree considering the investment costs is also shown in Fig. 8.10 above:

Considering the investment costs, the expected value decreases by EUR 0.63 million to EUR 1.13 million (see Fig. 8.11 above):

The Project Manager should also consider the risk probabilities of the potential results of an arbitration. The graph delineated below in Fig. 8.12 perfectly demonstrates that, even though in average a positive outcome of EUR 1.13 million is to be expected, the likelihood of incurring a loss of EUR 0.81 million is pretty high with 44%. The likelihood of getting more than the expected value is only 33.6%, whereas the likelihood to get less is 66.4%. However, in the event that the award is above the expected value, it will either be EUR 1.25 million or even EUR 3.59 million more

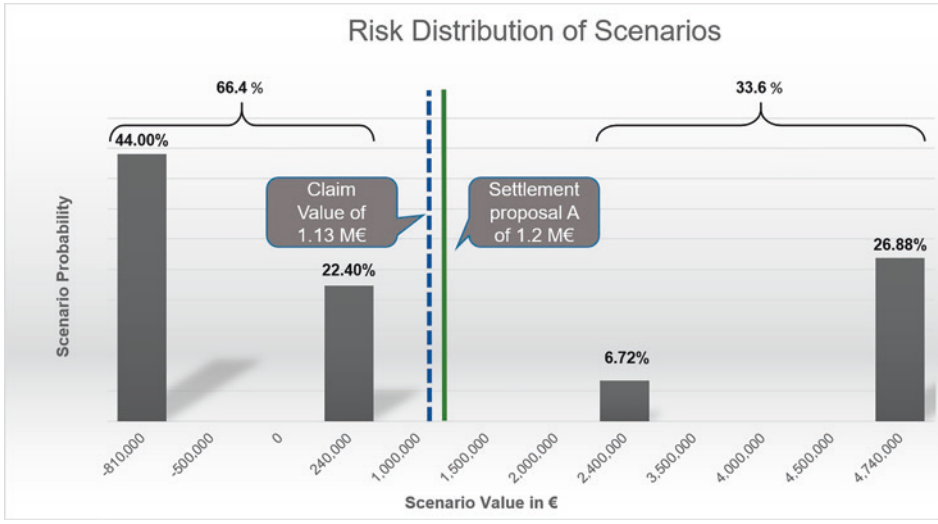

Fig. 8.12 Risk distribution

than expected. In case the award is below the expected value, it will either deviate by EUR 0.89 million with a still positive outcome (EUR 0.24 million) or by EUR 1.94 million and a negative result (EUR 0.81 million).

With any settlement above EUR 1.13 million, B is on average better off settling the dispute, rather than fighting it through arbitration. However, if A incurs further costs prior to the settlement, those costs need to be taken into account. In addition, the risk distribution can also not be ignored. There is a higher likelihood to get less than the expected value and a high risk of even incurring a (further) loss of EUR 0.81 million.

(b) **Decision:** Based on the above analysis, it is recommendable for B to accept A's ("last and final") settlement proposal. The chances to get a better result through arbitration are pretty low. Assuming B has to follow IFRS accounting rules, the booking of an opportunity under the EAC (Estimate at Completion) in a higher amount than the amount proposed for settlement by A will also not be an option as the EUR 1.13 million are the correct estimated value.

Explanation: Estimate at Completion (EAC)

Estimate at Completion is a method to forecast the total costs of a project, based on the costs incurred to date and the estimated costs to complete the project.

For **further reading**, see [4].

8.3 Implementation of the Decision

8.3.1 External Implementation

Re Task 1: Decision whether to repair the containers and if yes on how many platforms.
The implementation of the decision to repair the oil platforms does not require any contract amendment. The Project Manager of B has to inform Customer C about the decision to repair the accommodation containers to (i) avoid any further action from C (whether self-repair activities or legal actions) and (ii) coordinate the repairs with C.

Re Task 2: Assess whether to claim against A for compensation of the incurred repair costs of EUR 5 million.
After having decided to claim against A for cost compensation, the Project Manager will have to inform A accordingly. Usually such information is done by a claim letter containing the facts, the legal entitlement and the claim amount with a period for payment.

Re Task 3: Should B accept A's proposal to settle its claim for EUR 1.2 million?
B will have to inform A that the settlement offer is accepted. In such situations, the parties usually draft and sign a settlement agreement, explaining which claim has finally been settled by which payment.

8.3.2 Internal Implementation

Re Task 1: Decision whether to repair the containers and if yes on how many platforms.
When the decision to repair the containers has been made, the Project Manager has to inform the affected functions to buy the necessary material (**Procurement**) and to perform the repair work (**Projects**).

However, the Project Manager should document all aspects of the decision-making process in order to avoid liability of the board members ('Business Judgment Rule').

Contract Knowledge: Business Judgment Rule
The reason for this rule is to acknowledge that the daily operation of a business can be risky and controversial. Therefore, the board of directors should be allowed to make decisions without fear of being prosecuted. The business judgment rule further assumes that it is unfair to expect the people managing a company to make perfect decisions all the time. If the courts believe that the board of directors acted rationally in a particular situation, no further action will be taken against them.

Re Task 2: Assess whether to claim against A for compensation of the incurred repair costs of EUR 5 million.
Depending on B's claim management policy, internal approval might be needed before sending out the claim letter. A strategy needs to be agreed upon internally regarding how to address the claim. These processes and activities will be handled by the **Project Manager** or, if company B has such a function or department, by or with the support of **claims management**.

As A has already rejected any responsibility for the defects, the claim letter needs to address all issues of the above decision tree and the reasons why B believes the branch of the decision tree leading to full compensation in the amount of EUR 5 million is correct. B will attach the respective documentation to the claim letter with respect to the merits of the case as well as its quantum. Based on the agreed upon strategy, the Project Manager needs to collect all documents and draft a claim letter to A.

The **Legal Department** needs to review the draft, double-check required formalities and may add some legal references to the Consortium Agreement and the Master Contract with Customer C.

Re Task 3: Should B accept A's proposal to settle its claim for EUR 1.2 million?
The implementation of the decision to accept A's settlement proposal is strongly influenced by corporate management and in particular by governance considerations.

The **Legal Department** needs to get involved to draft or review the settlement agreement with A. The settlement agreement must mention the parties involved in the agreement, the background of the settlement, the amount to be paid by A and the issues covered by the settlement agreement. The Legal Department will also ensure that the settlement agreement will be signed by authorized signatories of both companies (governance).

The **Finance Department** will need to issue an invoice once the settlement agreement has been signed by both parties and to monitor the payment of A (cash-in for B). The Finance Department will also need to make sure the situation is appropriately booked.

Depending on company B's internal policies, the **Project Manager** might need further internal approval before accepting the settlement proposal from A. Furthermore, the Project Manager, or any other responsible person according to B's claim management policies, needs to update the claim database, if any (governance).

8.4 Process Optimization

Re Task 1: Decision whether to repair the containers and if yes on how many platforms.
There is hardly anything that could have been done differently.

In the case at hand, it is clear that the floors of the containers need to be repaired, however, the parties are of different opinions on who should perform the rectification work and/or who should pay for it. None of the parties wants to move first, being concerned with admitting responsibility ('First-Move-Barrier') and having to assume the (full) cost. Such a deadlock situation can be avoided by a contract clause, which provides for a quick dispute resolution process, which could either foresee a Dispute Adjudication Board or an Adjudication.

In both cases, the different opinions would be heard quickly by an independent Party and a decision on how to proceed would be rendered which is preliminary binding on the contract parties. If one of the parties does not agree with the decision, it must object within a defined period. However, the decision still needs to be followed until a Court/Arbitration Tribunal has rendered a finally binding decision. Such a clause would allow the project to proceed but grants the party access to justice, if needed.

Contract Knowledge: Adjudication and Dispute Adjudication Board

Adjudication is a process by which the parties involved in a dispute submit their differences to the decision of an impartial person (adjudicator) or group appointed by mutual consent or statutory provision. The adjudicator's decision is binding unless or until the dispute is finally determined by court proceedings, arbitration or by agreement of the parties via negotiation or mediation. If a party chooses to pursue subsequent proceedings, the dispute will be heard afresh—not as an 'appeal' of the adjudicator's findings.

For **further reading**, see [5].

Dispute Adjudication Boards are standing boards selected at the beginning of the project and are provided with the necessary and updated project documentation. Thus, the board can quickly render a preliminary binding decision as it does not need to get familiar with the project details.

Re Task 2: Assess whether to claim against A for compensation of the incurred repair costs of EUR 5 million.

The problems in the dispute at hand have been caused by imprecise provisions in the Consortium Contract ('liability for damages'). A clearer wording of the limitation of liability (so called 'cap') clause could have avoided the different interpretations of A and B. Rectification costs under defects liability obligations should be excluded from the limitation of liability as otherwise a consortium partner could refuse performing (costly) repairs and refer to the cap on liability. A preferable solution is presented under 2., Article X.3.5 in the Materials below. Since the **Legal Department** is responsible for drafting and negotiating the consortium contract, it should adapt its consortium contract template or its review requirements concerning templates of business partners accordingly.

On the other hand, the dispute results from different views on the underlying facts and their technical evaluation (defect in design or defect in workmanship; not negotiations in the legal sense). B would have had a better claim position if the negotiations with the Customer on the repair of the accommodation containers had been documented properly. With complete documentation, A could not make the argument that negotiations in the legal sense have not been taking place and that C's claim for repair is time-barred. Documentation is the task of the **Project Manager**.

Re Task 3: Should B accept A's proposal to settle its claim for EUR 1.2 million?
Decisions on whether or not to accept settlement proposals in claim situations can only be avoided by preventing claims in the first place or by not entering into any settlement negotiations. The first option is the goal of a good contract and commercial management but can hardly be achieved 100%. Not entering into settlement negotiations only makes commercial sense if better alternatives are available. The options at hand are (i) waiving the claim, which does not seem to be a better alternative for B and (ii) filing a lawsuit right away against A. The latter option might be a better alternative if B has a very strong case and can get an award in due course. Thus, in the given case, B had no better alternative to act.

8.5 Actual Execution

In the case at issue, B repaired all 25 oil platforms, incurred EUR 5 million repair costs and claimed against A for these costs. After a written rejection of B's claim, the parties met for a claim negotiation. A made the offer to settle the claim with a payment of EUR 1.2 million which was refused by B as B did not apply the Litigation Risk Analysis but evaluated the chances by averaging out the probabilities of the single arguments, ending up with an overall win probability of >50% and thus expecting the value of the claim to be at least EUR 2.5 million. Based on such an evaluation, B considered A's 'final' offer to be too low and started the arbitration process. Technical experts were heard, and the arbitration tribunal was convinced that the defect was at least caused by bad workmanship of both A and B. The arbitral tribunal was not convinced that the defect was a design defect because the experts had contradicting opinions. Based on the burden of proof, the arbitration tribunal decided based on the *non liquet* situation against B (who has the burden of proof). The tribunal awarded that A must compensate B with EUR 3 million and the costs of the arbitration are to be borne by A for 3/5th and by B for 2/5th.

B got lucky with the decision not to accept A's settlement proposal but it ran a high risk of getting less than the proposed EUR 1.2 million.

8.6 Learning Outcome

8.6.1 CM Value for the Case Study

The case study demonstrates that the CM Model allows a systematical approach to a situation in which a manager has to respond to a situation in project execution which affects two separate contracts, here a Customer Contract and a Consortium Contract. The options for the decisions to be made during project execution are limited based on the contractual provisions agreed upon at the end of the CM process step draft. The possibility that defects may occur during project execution was identified during contract drafting and was reflected in both contracts.

However, a contract only contains consequences for certain situations and assigns responsibilities (passive clauses). The dispute however arose based on (i) the underlying facts and (ii) the interpretation of some contractual provisions. The CM Model can be used in this situation to identify the BATNA which is based on the information available (knowledge management) as well as the litigation risk analysis (risk management).

Contract Knowledge: Active, Passive and Contextual Clauses
Contract clauses can be differentiated by active clauses (which describe the roles and responsibilities with respect to contract performance), passive clauses (which describe the consequences of non-performance) and contextual clauses (which describe the context).

For **further reading**, see [6], pp. 123, 366 and 522; [7], p. 84 et seq.

The comparison of the actual execution and the result of the Litigation Risk Analysis shows that the latter is only a tool to evaluate the value of the claim under consideration of a potential investment. It cannot predict the decision of a specific arbitration tribunal but is based on the average of a hundred decisions. It helps, however, to make an informed decision and gives a good legitimation for any decision made. It also shows potential outcomes and their likelihood. In our case, the chance of receiving EUR 3 million was estimated with 6.72% which means that almost 7 arbitration tribunals out of a hundred would decide likewise. The tribunal deciding the case (actual execution) was one of them.

The CM Model also helps increase awareness of the need to transform crucial experiences made in business execution through a lessons learned approach. Such deployment of knowledge management may contribute to the optimization of future transactions and thus support risk management and management of the transaction.

8.6.2 Case Study Value for the Reader

The reader learns about the performance of a contract by more than one party and the link of two contracts (Customer Contract and Consortium Contract) based on the same facts. He gains insights into the handling of situations after the contract has been signed in which the partners do not agree on the interpretation of facts and provisions and thus the respective consequences under the two contracts. He gets to know the legal concepts of defects liability, joint and several liability and dispute resolution as well as the decision tool of a litigation risk analysis.

The case study allows the reader to analyze the nature of a dispute occurring between consortium partners during project execution and to evaluate the claim value, whether for purposes of booking risks or for evaluating the BATNA in settlement negotiations. The reader also learns about the difference of the expected value, i.e. claim value as per litigation risk analysis, and the potential outcomes of a dispute which can be awarded by an arbitration tribunal.

Appendices

Excerpts of Relevant Clauses of a Consortium Contract

Article 1: Definitions
"Agreement" means this consortium agreement and its Annexes.
"Consortium Member" means any party to this Agreement.
"Contract" means the contract for the Project awarded by the Customer to all Consortium Members.

Article X: Liability

X.1 Liability towards the Customer

To the extent provided for in the Contract or in the law governing the Contract, the Consortium Members shall be jointly and severally liable to the Customer for performance of the Contract. As among themselves, each Consortium Member shall be liable for its Scope of Work.

X.1.1 Liability for Delay

…

X.1.2 Liability for Defects

The Consortium Member having caused a defect will be liable for this defect and any resulting claims of the Customer. However, any remedial work shall be executed subject to the terms of the Contract and subject to Article 13.3.1, by the Consortium Member in whose Scope of Work it is located or occurs.

X.1.3 Mitigation by Consortium Members

If the Customer has or can reasonably be expected to become entitled to a claim for non-compliance with the Contract and the Consortium Member responsible for this claim ("Responsible Consortium Member") is unable or unwilling to avoid, mitigate or resolve it and if the claim can be avoided, mitigated or resolved by measures initiated by the other Consortium Member not responsible for the claim ("Non-Responsible Consortium Member"), the Non-Responsible Consortium Member may make every reasonable effort to avoid, mitigate or resolve the claim, to the extent that the claim is likely to adversely and materially affect the Consortium or Non-Responsible Consortium Member.

X.1.4 Other Liability

…

X.2 Liability towards Third Parties

…

X.3 Liability of the Consortium Members with respect to each other

X.3.1 Allocation of cost for remedying Defects

If a Consortium Member must execute remedial work pursuant to Article X.1.2 without being liable for the respective defect, the Consortium Member who caused the defect shall advance or, in any event, indemnify the Consortium Member who must execute the remedial work for the direct costs, regardless of any right to seek reimbursement under any insurance policy. The direct costs shall include overheads, expenses for establishing the cause of and the responsibility for the defect, for additional measures necessitated as a result of the defect, for changes in the Scope of Work of the other Consortium Member necessitated by correction of such defect, and for repeat inspections or acceptance or other tests.

X.3.2 Design Changes and Design Freeze

…

X.3.3 Reimbursement of expenditure

The Responsible Consortium Member shall reimburse Non-Responsible Consortium Member for the direct costs and corresponding overheads, and the profit margin, incurred by the other Non-Responsible Consortium Member in avoiding, mitigating or resolving any claim in accordance with Article X.1.4

The same shall apply if a Consortium Member executes remedial work for a defect caused by another Consortium Member pursuant to Article X.1.2, in which case the direct costs shall additionally include expenses for establishing the cause of and the responsibility for the defect for additional measures necessitated as a result of the defect, for changes in the Scope of Work of the other Consortium Member necessitated by correction of such defect, and for repeat inspections or acceptance or other tests.

X.3.4 Other Damage caused to other Consortium Members

…

X.3.5 Limitation of Liability

Each Consortium Member's liability pursuant to this Article X.3 shall be limited to EUR 1 million per event. (Clearer alternative: This cap on liability shall not apply to any liability pursuant to Article X.3.3). In the event of a liability pursuant to Article X.3.3 (first paragraph), unless explicitly provided otherwise, no Consortium Member shall be liable to another Consortium Member for loss of profit, loss of use, loss of data or information, loss of contracts or business opportunities or any punitive damages.

The foregoing limitations and exclusions of liability shall apply to the extent consistent with mandatory law and regardless if the basis of the liability is contractual or non-contractual, or is based on breach of contract, breach of warranty, negligence, strict liability, tort or any other legal theory and shall also apply for the benefit of employees, agents, subcontractors and sub-suppliers of the responsible Consortium Member.

Structure of a Consortium Agreement

Content of a typical structure of a consortium agreement according to [9]:

ARTICLE 1: DEFINITIONS
ARTICLE 2: RELATIONSHIP OF THE MEMBERS
ARTICLE 3: PREPARATION, WITHDRAWAL RIGHT
ARTICLE 4: PARTIES' SCOPES OF WORK
ARTICLE 5: CHANGES, REDUCTIONS AND ADDITIONS
ARTICLE 6: PROJECT SCHEDULE
ARTICLE 7: MANAGEMENT OF THE CONSORTIUM, EXPENSES
ARTICLE 8: MEMBERS' RESPONSIBILITIES DURING CONTRACT PERFORMANCE
ARTICLE 9: FINANCIAL OBLIGATIONS, PAYMENTS, CONSORTIUM ACCOUNT
ARTICLE 10: REPORTS AND BOOKS OF ACCOUNT
ARTICLE 11: TAXES
ARTICLE 12: INSURANCES
ARTICLE 13: PATENTS, INTELLECTUAL PROPERTY
ARTICLE 14: CLAIMS MANAGEMENT
ARTICLE 15: DEFAULT OR INSOLVENCY
ARTICLE 16: CLAIMS BY THE CLIENT OR THIRD PARTIES
ARTICLE 17: WARRANTIES
ARTICLE 18: LIABILITY BETWEEN THE MEMBERS
ARTICLE 19: SECURITIES
ARTICLE 20: FORCE MAJEURE AND SIMILAR EVENTS
ARTICLE 21: CONFIDENTIALITY

ARTICLE 22: NOTICES, COMMUNICATION
ARTICLE 23: CORRESPONDENCE, COMMUNICATIONS
ARTICLE 24: DISPUTE RESOLUTION
ARTICLE 25: TERM OF THE AGREEMENT
ARTICLE 26: PROPER BUSINESS PRACTICE
ARTICLE 27: MISCELLANEOUS PROVISIONS

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The Leasing Case—Contract Impact on Accounting and Financing Objectives

9

Markus Ulrich

Contents

M. Ulrich (✉)
Schuster & Partner, Cologne, Germany
e-mail: ulrich@spgbr.eu

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Abstract

The present case study looks at the importance of the CM Model against the background of a bilateral treatment of leasing and rental contracts in combination with so-called covenant agreements that usually and most often constitute a part of company financing. It illustrates the importance of a comprehensive knowledge of the effects of contracts on the areas of accounting and financing and demonstrates the contract's considerable controlling effects on the overall decision-making process in terms of the CM Model. The case study further highlights which organizational rules are important in order to obtain this knowledge and, based on this knowledge, how to make the best decisions on the management level while taking the company objectives under consideration.

Keywords	Accounting, billing, financial and operational leasing, covenants clauses
Principle management topic	Compliance
Institution	Large enterprise, private, profit
Subject of management	Transaction, enterprise
CM process step	Plan, draft, evaluate
Management field	Risk management, knowledge management, corporate management
Contract type	Leasing contract, rental contract

Editor's Note: For a full understanding of the CM Model's practical benefit for the case study, the reader may have to peruse at least sect. 1.4.4 and 1.4.5 of Part I. The keywords used above to characterize the area of contract application are explained in the key system preceding the case studies in Part II.

9.1 Challenge

9.1.1 Set of Facts

A limited liability company under German law, a GmbH (Company A, also referred to as the Lessee) is a company with its place of business in Cologne. The company purpose is

logistics and transport, especially the provision shipping services for international online traders. The corporation that A is part of generated a consolidated turnover of about EUR 1.5 billion in the past year with a balance sheet total of EUR 500 million. According to statutory accounting regulations, Company A prepares subgroup accounts for the German company based on the German Commercial Code. As the parent company of Company A, Company O GmbH, with its place of business in London and a far-reaching international network, accounts are prepared on a higher corporate level in accordance with the regulations of the IFRS (International Financial Reporting Standards), as are additional accounts by the highest corporate parent company, Z Corp. with its place of business in Illinois, in accordance with the US-GAAP (United States Generally Accepted Accounting Principles). The general meeting of the highest parent company, i.e. Z Corp, has appointed the international auditing company W to audit the accounts and has commissioned it with auditing all individual accounts and the consolidated group accounts.

Years ago, Company A already concluded a comprehensive financing agreement for company business with the banking group K with a total volume of EUR 200 million, which is currently at about that level of debt. The loan agreements with K contain far-reaching covenants regarding the operating figures. According to these, the financing conditions are dependent on, amongst others, the total equity base, the level of debt as a relation of equity to borrowed capital, the absolute result of ordinary business excluding other operating income, and the absolute figures for the working capital. In particular, the lender K may demand higher interest payments when the financing conditions worsen by 0.5% in case of a minor negative deviation of the equally weighted mix of operating figures in the covenants of 10 percentage points.

In 2018, Company A decided to lease 750 delivery vehicles (order value about EUR 50 million) from a German vehicle manufacturer B (Lessor) for its department. The leasing rates and the annual burden of the lease on Company A under the vehicle leasing contracts were planned by the Management of A and have been coordinated with the financing banks, the banking group K. The delivery vehicles have an estimated service life of 5 years.

The following is regulated under an already negotiated contract draft (hereinafter also simply referred to as '**LCplan**'):

- the non-cancellable lease period is 5 years;
- the Lessee A may purchase the leased items after expiry of the lease at a fixed purchase price of 5% of the gross list price (call option).

As an alternative, B has offered leasing for a fixed lease term of 3 years without the option to sell or buy (hereinafter also simply referred to as **'LCalt'**). The Management of A, however, has rejected this version of the contract because of the lease time that was considered to be too short, even though from an economic point of view, the conclusion of a new leasing contract after three years for new vehicles would not be substantially more expensive.

Simultaneous to the conclusion of the leasing contract, a lease between A as tenant and C as landlord is to be concluded, and a garage and parking lot for the leased vehicles are to be set up on the rented premises.

The present draft of the lease agreement between A and C (hereinafter also simply referred to as '**RCplan**') include the following covenants, amongst others:

- the lease has a fixed term of 10 years;
- the tenant A undertakes to remove any installations or changes to the rented property at the end of the lease and to restore the rented property to its original condition.

As an alternative, the landlord C offered a term of 10 plus 10 years, without installations made by the tenant having to be removed (hereinafter also simply referred to as '**RCalt**'); this alternative, however, was not desirable to the Management of Company A, even though long-term leases are indeed in the interest of the Company. The following structural units of Company A were involved in drafting the contract:

- The Management of Company A (hereinafter referred to as: the Management) is the central body for all company decisions. It is responsible for achieving company objectives, which in the present case can be described as the permanent optimization of return on capital of the company subject to general compliance principles.
- The legal department of Company A is a central company division subordinate to the Management whose duties include contract management, i.e. contract planning, preparation, and archiving in particular.
- The vehicle fleet and logistics department of Company A is an independent company division subordinate to the Management and is responsible for managing the company fleet, including all logistics activities.
- The purchase and procurement department is involved in this process with regard to preparation of a market analysis and market report. This department had no further involvement in the processes and will therefore not be examined further in this case study. The selection of suppliers and the contract negotiations and preparation were handled by the vehicle fleet and logistics department and the legal department.
- The department corporate accounting is a division immediately subordinate to the Management and is responsible for accounting, preparing annual financial statements, supporting audits, monthly reports to the Management including compliance with the tax obligations of the company.

The processes for drafting rental and leasing contracts at Company A usually play out as follows: In the drafting phase, Company A's legal department submits the contracts to A's Head of Corporate Accounting, R, if a review is necessary from an accounting point of view. The Head of Corporate Accounting assesses the consequences for the accounts resulting from the draft text and quantifies the material effects on the asset, financial, and income situation. If the Head of Corporate Accounting considers the matter to be too

complex, the draft is submitted to Company A's Management in order to obtain an expert opinion from the auditor W who is in charge of the annual financial statement. With a view to the monthly reports that must be prepared as well as their informative value, the coordination with the auditor is intended to prevent the annual financial audit leading to a different assessment of matters by the auditor than internally in the Corporate Accounting department.

This procedure is expedient from the point of view of the company because these processes are matters where a different accounting-related assessment by the company, on the one hand, and the auditor, on the other hand, may result in a restriction of the audit opinion, which in turn could affect the rating of the company by banks, suppliers, credit insurances, and similar.

In the present case, the drafting of the leasing and rental contracts is supported by A's legal department, both with regard to technical details and terms, leasing rate, and the right to sell, and the details are coordinated with the vehicle manufacturer B by the logistics department. A's Department of Corporate Accounting has not been involved in the lease and renting activities at first, due to the non-automated mandatory involvement of the Department of Corporate Accounting. Only after the contracts had been submitted to the Management for signing did the Management query involvement of the Head of Corporate Accounting, which was negated.

The Management subsequently asked R for a statement as to whether there were concerns from an annual accounts point of view. When R confirmed such concerns, the Management referred the matter back for resolving the accounting issues. Furthermore, the Management ordered the Head of Corporate Accounting to analyze process flows at the Company A together with the auditor W, and to resolve the legal and accounting questions that arise when company processes are applied in due form and which have to be considered in the drafts of the lease and rental agreement. The goal is to exclude or at least minimize the risk of audit opinions not being granted by already putting organizational precautions in place at the contract drafting stage.

9.1.2 Operating Procedure

9.1.2.1 Author's Explanations

The present case makes it clear that a transaction is not only decided by the immediate circumstances of the transaction, but is also based on factors relating to its environment, in this case, the legal accounting regulations, other obligations (here the financing agreements with the banking group K), and the internal procedural structure of the company.

(a) **Contractual Management cycle:** For R, the tasks mean a focus on the CM process steps 'plan' and 'draft' (pre-award phase) of the lease and rental contract. As regards content, the question is what the draft contract should state, not only to

meet the technical and legal requirements, but also to take the overarching company objectives into account. This especially results in the questions as to whether the involvement of all pertinent management areas at the drafting stage is already ensured, and whether the drafting of contracts is controlled by the management areas in the way that is best for ensuring achievement of the company objectives.
Another focus is the CM process step 'evaluate,' since the Management of Company A also wants to know how it can be assured in the future on the content-related and organizational level that the conclusion of leasing and rental contracts does not jeopardize the audit opinion and that the conditions of the loan agreements are complied with, so that the financial standing of Company A is not undermined.

(b) As regards to the **CM management fields**, R will mainly have to focus on knowledge, risk, and corporate management, and with regard to the latter especially on corporate governance and compliance management. A closer analysis of these management areas automatically leads to the relevant technical questions.

Knowledge management What knowledge is required to assess the contracts and where is this knowledge available? The relevant knowledge in this case particularly refers to the requirements for accounting (Sect. 9.2.1.1.1) and the financing agreement (Sect. 9.1.2.1.2). When is external support required, i.e. the help of an auditor beyond the general audit of the annual financial statement (Sect. 9.1.2.1.3)?

The requirements for accounting necessitate a look at the different accounting standards:

9.1.2.1.1 Accounting Standards

Explanation: National and International Accounting Standards
The accounting standards pursuant to the German Commercial Code (HGB) are set out in sections 238-342e HGB (Third Book of the Commercial Code). These sections regulate provisions on accounting obligations, disclosure, approach, and valuation in annual financial statements and consolidated financial statements, as well as on notes and management report, audit, retention and disclosure obligations, and sanctions in case of violations.

Accounting subject to the International Financial Reporting Standards (IFRS) is based on the standards of the International Accounting Standard Board (IASB), a private commercial body with place of business in London, that cooperates with the IFRS Interpretations Committee which is independent form the IASB. This institution supports the utilization of the standards issued by the IASB (IFRS and IAS) and the respective interpretation being prepared by the IFR Interpretations Committee (IFRIC). The standards are binding for consolidated financial statements of companies in the EU that are active on the capital market (trade in company shares and bonds on the regulated market of an EU Member

State) (endorsement by the European Commission in accordance with Regulation 1725/2003 [4].

Accounting based on the United States Generally Accepted Accounting Principles (US-GAAP) is particularly relevant for companies that are listed on the US capital market or that issue bonds in that market, as the Securities and Exchange Commission (SEC) can make them mandatory for the companies. These standards are issued by the Financial Accounting Standards Board (FASB).

In detail, the accounting standards, excerpt of which are reproduced in Appendices (Tables 9.1 and 9.2), have the following specific impact on leasing agreements:

Accounting pursuant to the HGB: Pursuant to section 246 clause 1 second sentence HGB, an asset has to be allocated to the beneficial owner. Since the HGB does not provide any detailed regulations on determining the beneficial owner, the generally accepted accounting principles are applied, which for lease deals are based on the four leasing decrees issued by the BMF (financial administration). This procedure was confirmed by the legislator with the German Accounting Law Modernization Act (BilMoG). Depending on the allocation of beneficial ownership, the lease deal is treated either as an installment purchase contract (with listing in the balance sheet of the Lessee) or as a lease (without effects on the balance sheet of the Lessee) [1, 2].

Accounting pursuant to IFRS: Following many years of intensively debated development, the new leasing standard IFRS 16 was published on January 13, 2016, replacing the former leasing standard IAS 17. The new standard applies immediately, but no later than for the business years starting on or after January 1, 2019 (IFRS 16.CI). The reason for the review was the option under IAS 17 for having leasing deals neutralized for balance sheet purposes. Similar to the procedure under the HGB, the lease was not disclosed on the balance sheet of the Lessee if beneficial ownership was attributed to the Lessor. By way of corresponding contract clauses, it was possible to deliberately avoid having assets and obligations under the lease agreement entered for the Lessee (off-balance sheet accounting) and important information could be withheld from the addressees of the financial report (IFRS 16.BC3). According to the IASB, about 85% of global leasing volume under the IFRS and US-GAAP were not recorded on balance sheets [3, 5, 7].

With the right-of-use-approach under IFRS 16, the Lessee now always has to list a right of use and a leasing liability for every identified leasing deal. Exceptions are only available for short-term leases of minor value for which IFRS 16.5 stipulates an option for disclosure. As regards the Lessor, however, the regulations under IAS 17 were largely adopted as they were (see [3, 7]).

Accounting pursuant to US-GAAP: The new leasing regulation ASC 842 was published on May 25, 2016 and must be used by public business entities for the business years starting after December 15, 2018 and by other businesses for the business years starting after December 15, 2019. It may be utilized before those dates (ASC 842-10-65-19). The reason for the review of the leasing conditions codified previously in the ASC

840 (formerly SFAS 13) was, as for the IAS 17, the option for having leasing deals neutralized for balance sheet purposes of the Lessee. Furthermore, the US-GAAP had also stipulated quantitative limits for the classification of leasing deals that made it easier for the contractual parties to achieve the desired allocation of the leased item [5, 7].

Originally, the disclosing of leases on balance sheets was to be standardized as part of a cooperative project between the IASB and FASB. Yet, while the IFRS 16 and ASC 842 are largely identical, there are still some differences due to the different ideas of the two standardization entities [7].

To summarize, it has to be noted that the accounting for leasing deals is subject to considerable differences between regulations under the German Commercial Code and the international standards. According to the HGB, beneficial ownership results in leased items being listed by either the Lessee or the Lessor so that they might be neutral for the balance sheet of the Lessee. According to the IFRS 16 and ASC 842, the Lessee always has to list a right of use and a leasing liability. Only short-term leases (IFRS and US-GAAP) and leases of minor value (only IFRS) are subject to the right to choose.

According to the IFRS 16 and ASC 842, on the other hand, the Lessor has to decide, similar to the procedure under the HGB, if the leasing of the leased item constitutes a transfer of beneficial ownership to the Lessee. In general, the IFRS 16 and ASC 842 do largely agree, but full convergence was not achieved [7].

9.1.2.1.2 Financing Conditions, Especially Covenants

Obtaining knowledge regarding the covenants requires studying the relevant clauses of the loan agreements and an analysis of these contractual parameters in order to make a sensitivity analysis possible. This has to be done separately for each corporate level.

Contract Knowledge: Covenants

Covenants are additional agreements in loan agreements that are designed to ensure, from the point of view of the lender, that the lender receives compensation in the case of a substantial deterioration of the economic situation of the borrower and in case of legal changes at the expense of the lender.

These often set out financial performance indicators such as, for example, equity ratio, level of debt, asset cover ratio and/or they define ranges.

These are individual figures included in additional agreements that are usually based on the performance figures when the loan agreement is concluded, even though so-called non-financial covenants, e.g. *pari passu* clause (equal rank of claims), pledge agreements (equal rank for in rem securities), cross-default clause (special right to termination in case of general delay of payment) or corporate financial covenants (regulations regarding dividends, company and shareholder situation, restructurings, and others) may also be added.

Risk management The parameters for the draft of the lease or rental contract are not solely based on these transactions themselves, but also on the objectives adopted by the Management. Disregarding matters of accounting law of the lease and rental contract carries the risk of restricting the audit opinion, which in turn effects the rating of the Company with banks, suppliers, credit insurers etc. Additionally, non-compliance with the covenants in the loan agreements increases the risk of higher financing costs or extraordinary termination by the group K, which in turn might have a negative impact on the rating of the borrower A.

9.1.2.1.3 Involving an Auditor

On the one hand, this brings up the question of generally when it is advisable to involve an auditor—beyond the general audit of the annual financial statement as required by law—and, on the other hand, of how the auditor should be involved in the present case. The general question will be addressed in the following steps of the analysis. In the present case, hints can already be found in the steps taken by the Management, which also allow for individual conclusions regarding the general involvement of an auditor. In this case, the Management commissioned W to support R in the audit, since the internal control system of Company A was apparently unable to guarantee that the effect of a contract on the balance sheet did not only take the immediate effects on the balance sheet into account, but also identified consequences that go beyond that and the resulting risks. If this control system suffers from deficits, there is the risk of a lack of control that creates compliance risks and constitutes a weakness in corporate governance, which in turn may lead to negative personal consequences for the Managing Director.

This leads to the transition from the management field ‘risk management’ to the subsequent ‘corporate management’.

Corporate management Has the Company adopted regulatory rules regarding compliance management so that the information and controlling mechanisms implemented into the procedural structure ensure that the Management receives information about all crucial decision paraments during Contract management? Are the management processes optimized in order to guarantee achievement of the Company objectives?

Relationship management The management of transactions, i.e. the actual leasing and rental contracts, is of only peripheral relevance for the present purpose, not because of the transaction as such, but because its (internal) assessment from the point of view of the auditor is the key element. Incidentally, a review of the CM process steps ‘implement’ and ‘monitor’ may result for the transaction as well.

9.1.2.2 Reader’s Tasks

Using the CM Model as a guide, the reader is to determine, based on the facts provided, how the leasing and rental contracts can be optimized and risk-minimized from a

commercial point of view. The facts as described above thus lead to a multi-stage question. To begin with, it is aimed at the drafting of the lease and rental contract:

- Which basis is to be used for assessing the effects the lease and the rental contract have on the balance sheet?
- What are the effects on the balance sheet based on the assessment of the accounting-centered analysis of the situation?
- Is the knowledge basis of the Company sufficient to come to a final assessment of the situation without running the risk of the auditor arriving at a different conclusion regarding the effects on the balance sheet in a later audit of the annual accounts? Given the complex assessment of leasing contracts, it has to be determined whether the auditor should already be involved and give his opinion during the process step 'plan'.
- What are the consequences of the assessed effects on the balance sheet? Where applicable, are covenants of loan agreements affected because fixed balance sheet figures set out in the agreements cannot be met?
- Can a possible violation of covenants be quantified in terms of a calculation of the higher financing costs resulting from the circumstances?

Based on the specific questions in this case, the reader is to develop ways to optimize the contract management processes in compliance with the Company objectives. This especially leads to the following questions regarding optimization of management procedures:

- How must management procedures be set up in order to allow the Management to make a decision based on all relevant decision parameters when drafting contracts?
- Are all relevant company departments involved in the process?
- Are interactions between these relevant company departments and the Management implemented?

All in all, you are requested to take the position of R, the Head of Accounting, and to process the following tasks:

Task 1: Make decisions regarding which of the options for the leasing contract and which of the options for the rental contract should be realized. (Level of difficulty: High)
Task 2: Explain how the decisions of the Management should be implemented. (Level of difficulty: Low)
Task 3: Make a proposition regarding the organization of Company A's internal processes as regards the observation of accounting standards when concluding leasing or rental contracts. (Level of difficulty: Medium)

9.2 Decision-Making Process

Task 1: Make decisions regarding which of the options for the leasing contract and which of the options for the rental contract should be realized.

9.2.1 Identification and Evaluation of the Decision-Making Circumstances

The Head of Corporate Accounting R will initially determine, together with the auditor W, the legal framework for disclosing the envisaged leasing contract in the accounts, for disclosing the envisaged rental contract in the accounts, and for the analysis of the loan agreements with regard to any pertinent clauses. Subsequently, the two will determine the economic parameters of the decision. To be determined in this context are quantitative monetary parameters, stemming from the leasing and rental contracts, and the potential risk arising from covenant agreements must be quantified. Both processes are closely related to knowledge management, and the risk approach seems to offer itself as a good criterion for their assessment.

9.2.1.1 Accounting Aspects

Relevant for the assessment of risk management are, on the one hand, legal regulations governing the disclosing of leasing and rental contracts on the balance sheets and, on the other hand, the covenant agreements as mentioned in Sect. 9.1.1 for quantifying any associated risk.

As regards knowledge management, the Management has to decide whether the internal knowledge concerning the accounting questions that arise is available.

9.2.1.1.1 Leasing Contract

The underlying question in the assessment of the legal regulations concerning the accounting of leasing contracts ultimately is who the **beneficial owner of the leased item** is. Is that the Lessor B or the Lessee A?

Usually, the first constellation is the desirable one, i.e. accounting for the leased item in the accounts of the Lessor, because the Lessee usually opts for a leasing contract (in operational leasing as basis for a leasing relationship) over a purchase contract for the item (financial leasing is then ultimately a form of funding purchases) for reasons of not having to disclose the leasing contracts on the balance sheet. If the Lessee is not the beneficial owner, the lease payments made by him are listed as expenses, the leasing contract does not affect his balance sheet (off-balance) and therefore has no impact on the balance sheet figures. If the Lessee is the beneficial owner, the situation would be different: He would then disclose the leased item as an asset in his balance sheet, and the cumulated liabilities stemming from the lease payments will be listed as liability on his balance sheet. This results in a change to the balance sheet, i.e. in an increase of the balance sheet total, which affects balance sheet indicators.

In order to assess the question of who the beneficial owner of a leased item is, the following regulations and/or standards (in parts reproduced in Appendices: Tables 9.1 and 9.2) must be taken into consideration, but these have to be assessed on a case-by-case basis according to their legal commentaries at the time in comparison with the leasing contracts that are to be concluded:

- Assessment criteria for the various accounting systems pursuant to the HGB letter concerning treatment of leasing contracts for moveable assets for taxes on earnings from April 19, 1971 [1].
- Regarding IAS 17 and IFRS 16: After more than ten years of discussions, the International Accounting Standard Board (IASB) published the new Leasing Standard IFRS 16 'Leases' on January 13, 2016. After endorsement, the new standard becomes binding for all companies whose account is based on the IFRS from January 1, 2019 [3].
- Decisive for the assessment of leases pursuant to the US-GAAP is the standard US-GAAP (ASU 2016-02 'Leases' [5]).

The comprehensive regulations and their interpretation, especially regarding IFRS and US-GAAP, are the reason for the uncertainties that usually arise in corporate accounting and thus for the Management when assessing the accounting-centered treatment of leases and the resulting risk of a deviating assessment by the certifying auditor.

9.2.1.1.2 Rental Contract

An obligation to disclose allowances for restitution is set out in section 249 HGB, IAS 37, and the US-GAAP standard for liabilities.

From the point of view of a company, making allowances means listing a later payment obligation on the balance sheet, a listing of the corresponding expenses on an accrual basis, and thus the reduction of the company value and the reduction of shares in profit of the shareholders.

Creating allowances pursuant to the German Commercial Code and/or the listing of liabilities are based on the fact that Company A is assuming an obligation for later payment with the conclusion of the rental contract as drafted in RCplan, namely to return the rented property to its original condition after the rental contract has expired, and that this obligation, even though payable at a later time, is assumed when the rental contract is concluded.

This obligation is valued at the estimated fulfilment value, that is, the estimated costs for removal of installations when the rental contract ends (usually determined based on the current costs and a projection of expected fixed rates of value increases), applying discounts on the present value.

9.2.1.1.3 Feedback Effects of the Financing Agreements (Covenants)

In order to quantify the accounting-related assessment of inherent risks of the leasing or rental contract as part of risk management, the loan agreements of the Company must be analyzed with regard to their covenants.

In this particular situation, A's existing loan agreements must first be analyzed with regard to the question as to whether there are relevant covenants. This is the case in the present case study. When the loan agreements were concluded, four indicators regarding

- absolute equity base,
- level of debt as proportion of equity to borrowed capital,
- absolute minimum of the result of ordinary business operations excluding other operating income, and
- an absolute indicator regarding working capital

were contractually agreed upon, based on the information available when the agreements were concluded.

In each case of a reduction or worsening of the fixed indicator mix by 10%, the interest rate increases incrementally by 0.5 percentage points. For the Company, this results in the loans becoming more expensive by about one million Euros (0.5% of bank liabilities of EUR 200 million).

9.2.1.2 Business Aspects

In addition to the legal aspects set out in Sect. 9.2.2 and the associated effects the leasing and rental contracts have on the balance sheet, the conclusion of such contracts is primarily subject to profitability considerations. This means that the leasing and the rental contract are analyzed with regard to their economic contribution to the Company using the calculation method of the investment theory ([3], pp. 55 et seq). The conclusion of a usually multi-annual contract utilizes and binds finances of the Company for the leasing of items, which in turn are to generate a positive output for the Company. Based on an initial need for investment, the contractual components for leasing rate, rent, term, and the remaining conditions must be drafted so that the financial means used allow for a return on investment in accordance with the Management guidelines.

As part of risk management, however, contract drafts must be examined by the Management with regard to the effects of the draft proposal on the asset, financial, and income situation of the Company as a whole. The conclusion of the leasing and rental contract and their economic effects may be an advantage for the Company when taken by themselves, but entering the leased item in the assets of the Lessee can create disadvantages for the Lessee on another level, such as the financial one (Sect. 9.2.1.1.3), which are not relevant for decisions if the leasing contract is assessed in isolation. This means that the economic efficiency aspects cannot be reduced to the leasing contract during risk management but must also be extended to include the effects of the leasing contract on the financial statement of the Company. The same applies to the rental contract: When concluding the rental contract with the restitution obligation, there is an obligation that must be validated and which the Company must list as a liability accordingly; in this case, the shorter term of the rent contract was the decisive point (RCplan), as this was considered to be more favorable than the contract option with the longer term

(RCalt). By entering the allowance as liability, however, equity is reduced and the liabilities with indirect effect on the financing conditions increase.

9.2.2 Preparation of the Decision

Three steps must be completed to prepare the decision on the wording of a leasing contract:

(a) Exploring the possibilities for the form of the leasing contract with the Lessor in accordance with the Lessor's specifications with regard to the term of leasing contracts, leasing rates, form of lease extension options and/or purchase options, usual service life of the leased item, and where applicable, particulars (customization) for the Lessee. The same applies to the rental contract. Here, the economic parameters and their ranges must be analyzed and recorded.
According to the set of facts, this affects the contract alternatives LCplan and LCalt for the leasing contract and the alternatives RCplan and RCalt for the rental contract, whereby the assumption is that in case of an isolated assessment, i.e. limited to the contract only, these alternatives are equivalent on the economic level and that there are no discernible advantages on that assessment level.

(b) In a further step, the accounting framework for the treatment of leasing contracts on the different levels (HGB, IFRS, US-GAAP) must be identified. This question is legally complex and there is not always an unequivocal interpretation of legal regulations in literature and legal commentaries [6]. It is therefore advisable to already involve the auditor on this first level of accounting-centered assessment of the leasing contract, if required, in particular if the Management, including Corporate Accounting, does not have all necessary knowledge available.
The leasing contract has to be assessed from an accounting-centered point of view based on the principles of different treatment in accounting according to the accounting systems pursuant to HGB, IFRS, and US-GAAP as set out in Sect. 9.2.1.1.
With regard to the specific situation, it has to be expected that the leased item is entered as an asset of the Lessee A in case of LCplan, irrespective of the accounting principles (financial leasing). When recording the cumulated discounted lease payments as liabilities for the Lessee A and regarding the contract alternative LCalt, we would see recording as an asset by the Lessor B and the lease payments would be recorded as rent for the leased property by the Lessee A (operational leasing).
Concerning the lease situation, the result is the following:
  – LCplan: lease item listed in the accounts of Company A and registration of a liability;
  – LCalt: lease item not listed in the accounts of Company A, registration of the lease payments as periodic expenses.

Concerning the rental contract situation, the following constellation emerges:
- RCplan: creation of allowance for restitution by the tenant;
- RCalt: no creation of allowance for restitution by the tenant.

(c) Based on the leased item being listed in the accounts of Lessee and registration of a liability (LCplan) and the creation of an allowance for restitution by the tenant (RCplan), the effects of the corresponding covenants must be identified and, in the case of a violation of these regulations (here: reduction of the equity ratio below the limit specified in the loan agreements), quantified in the form of an increase of financing costs.

This means that in the case of LCplan and RCplan, accounting would result in a worsening of the level of debt and a reduction of profit for two of the four parameters of the covenants by a total of 12% and would therefore have an effect on the financing conditions, in this case, namely, the interest rate.

9.2.3 Making the Decision

Based on the available information, corporate accounting must develop, together with the auditor W, an optimized draft of contractual parameters for the asset, financial, and income situation of the Company.

This decision should be made on the basis of all factors required for preparation of the contract as stated. These are the relevant details of the leasing contract itself with regard to a commercially sensible use of the leasing contract (leasing rate, leasing term, possible purchase and lease extension options). If this best possible contract-relevant information results in the desired off-balance nature of the lease item for the Lessee and if the leasing and rent contract do not negatively affect the financing conditions, the decision-making process in this case can be translated into a final draft and contract conclusion (implementation) without problem.

The decision-making process becomes more complex if all—or even only one—accounting standard (HGB, IFRS or US-GAAP) results in an undesirable accounting situation regarding the leased item for the Lessee, and if an isolated assessment of the leasing contract only indicates that the present contractual parameters are the best possible and economically desirable parameters.

At this stage, interests have to be weighed and/or a change to contract clauses has to be considered in order to avoid economic risks.

9.2.3.1 Decision Pros and Cons

The pros and cons analysis includes the numeric evaluation of the different drafts based on a decision-making matrix. To be recorded on one side are the variations of the leasing contract and their effects on the balance sheets within the different accounting systems. To be recorded on the other side are the potential effects on the financing conditions pursuant to the covenants for each of the drafts. This is the basis on which the best solution, from an economic point of view, can be determined.

Applied to the situation, an isolated economic assessment of the contracts subject to an assumed economic equivalence of the contracts results in the following constellations:

(a) LCplan: the leased item entered as an asset by the Lessee A; higher financing costs due to violation of the covenants;
(b) LCalt: the leased item entered as an asset by the Lessor B; no higher financing costs stemming from a violation of the covenants;
(c) RCplan: higher financing costs due to violation of the covenants;
(d) RCalt: no higher financing costs stemming from a violation of the covenants.

9.2.3.2 The Decision

Based on the Management's analysis with the help of the relevant company departments such as logistics, vehicle fleet management, and legal, and, if required, with the help of the external auditor, the Management must make a decision regarding the content of the leasing contract that is concluded, which must be in the interest of the Company. These are recorded in the final draft and are the basis for signing the contracts.

The head of corporate accounting shall thus submit the following recommendations for a decision to the Management of the Company:

The contract alternatives LCalt and RCalt are to be selected and implemented because these drafts are in line with the Company objectives and because the other two options stand in contrast to them.

9.3 Implementation of the Decision

Task 2: Explain how the decisions of the Management should be implemented.

9.3.1 External Implementation

The agreement of the Management regarding the content of the leasing contract and the rental contract with the **parties to the contract** must be implemented by the corresponding conclusion of contracts. In accordance with the deliberations of R and W, the contracts should implement the alternatives LCalt and RCalt.

Alternatively: If the Management of the Company should decide in favor of the original alternatives of the contracts (LCplan and RCplan), and if the Company suffers consequences due to the failure to take the effects of the contracts on the balance sheet and the associated violations of covenants into consideration, the implementation of those contract alternatives must also be communicated to the **lenders**, the group K, and where applicable also to the **shareholders**, if required by the Company's articles of association.

9.3.2 Internal Implementation

The implementations of the decision on the contract version must therefore be communicated to the company departments that are involved.

These are:

- the legal department of the Company: usually involved in these processes anyway by way of contract drafting and closing,
- corporate accounting: the final leasing contract and the rental contract must be made available to corporate accounting,
- the vehicle fleet and logistics department: the contracts must also be submitted to this department so that the corresponding implementation, e.g. organizational and operational handover of vehicles and transfer on the rented premises can take place.

The notification of implementation of the contracts to the different company departments is a logical conclusion of the above arguments that have shown that an interaction between the individual sections of the Company is necessary in order to steer the management process in the areas of knowledge management and risk management in a manner that ensures that the drafting and implementation of a contract are in line with the company objectives. Accordingly, the company departments that are involved in the latter should have access to the contracts that will then have to be implemented.

9.4 Process Optimization

In accordance with the set of facts, the Management did not involve Corporate Accounting in the drafting of the contract until the last minute before closing. This resulted in a lack of control that considerably increased the company risks.

Task 3: Make a proposition regarding the organization of Company A's internal processes as regards the observation of accounting standards when concluding lease or rental contracts.

The basis of the deliberations of R and W is, on the one hand, the specific event of ordering the delivery vehicles, in which corporate accounting either was not involved until it was too late or not at all, and, on the other hand, the need to ensure that a contract is reviewed for compliance with the accounting and financial requirements placed on the Company, generally reviewed, and, where necessary, optimized before its conclusion.

9.4.1 External Processes

Given the background of the above deliberations, it becomes clear that interactions between the Management and the responsible company departments and external actors are necessary at a very early stage of the CM process step 'plan'.

The external parties include, on the one hand, the **parties to the contract**, here the Lessor and the landlord. In accordance with the arguments made above, the treatment of the leased item under accounting standards will also be a matter of interest for the Lessor during contract negotiations. Thus, there is a joint interest in finding a solution that is also desirable from an accounting point of view, in addition to reaching an agreement on the remaining economic parameters.

Contracts that result in complex accounting situations with additional effects on the asset, financial, and income situation of the Company, require the involvement of the **auditor**. This is to prevent any negative financial effects that may result from a leased item having to be listed as an asset on the balance sheet of the lessee based on the findings of the auditor, contrary to a previous own opinion, which could lead to problems with any covenants in the loan agreements of the Company. Where necessary, such involvement shall be arranged for by the Management together with corporate accounting.

Furthermore, the **banks** in question as well as any **shareholders**, where applicable, must be informed and/or involved in the case of covenants being violated.

This involvement of external parties must be defined in Company A's corresponding **organizational rules** of and compliance with these must be ensured with suitable measures.

9.4.2 Internal Processes

R and W will propose a procedural structure in accordance with the requirements set out above to the Management. It is necessary to implement processes that ensure the interaction between the departments vehicle fleet/logistics, legal, and corporate accounting. The Management plays a coordinating role in this process and has the decision-making power that the procedural structure assigns to it anyway.

In the present case, the Management of A has only integrated the departments legal and vehicle fleet and logistics into the procedural structure. There were no provisions made for a mandatory involvement of the department corporate accounting in the procedural structure for the relevant contracts, which should be corrected now in any case.

The following paragraphs outline how the processes are to be structured in order to create a management structure across all relevant management areas and regarding all relevant process steps of contractual management.

It is necessary to institutionalize an interaction between the departments

- Legal,
- Vehicle fleet and logistics and
- Corporate accounting

that bundles the information processes in the Management as superior company unit. The parameters that the department vehicle fleet and logistics have negotiated with the vehicle manufacturer serve as the basis for this. In cooperation with the Management, the parameters and, where applicable, a first draft of the contract by the Lessor, will be submitted to the legal department, which in turn is responsible for the legal assessment of the contracts and which reviews the rental contract for the premises.

As the next necessary step for efficiently using the contract as a management instrument, this information must be submitted to the department corporate accounting by the legal department during the planning phase for a review of possible effects on the balance sheets.

This poses the challenge of recognizing if contracts may affect the balance sheet. As regards leasing and rental contracts, this is obviously the case, but it is preferable to define the potentially problematic types of contracts first and to add them to the corresponding checklist for contract risk management. Where required, the staff of the legal department must be trained accordingly and updated at regular intervals. The internal accounting department should be defined as the standard contact partner for these matters.

Corporate accounting will determine the accounting risks and also the financial risk associated with the covenants. As the Company prepares financial statements subject to different accounting standards, and may therefore also be subject to different covenant regulations under the various accounting standards, the Head of Corporate Accounting also has to decide—with regard to the complex treatment of leases under the different accounting standards HGB, IFRS, and US-GAAP—whether obtaining an expert opinion from the auditor charged with reviewing the annual financial statement is required for verification of the correct accounting-related assessment of the situation.

These structures must be included in the corresponding **organizational rules** of the Company and compliance with these must be ensured with suitable measures.

9.5 Actual Execution

In the present case, the lack of procedural regulations and/or their deficient implementation resulted in the risk that the leasing contract and the rental contract could have been concluded with wording that would have been damaging to the financing conditions.

In the present case (as is commonly the case in real life), the different departments that are subordinate to the Management had or have limited knowledge of the overall legal situation of the Company and therefore do not have the necessary knowledge base for making decisions such as in the present legal matter of which contract best achieves the Company objectives:

- The vehicle fleet and logistics department was or is aware of the technical needs and other regulations under leasing contracts such as term and leasing rate.
- The assessment of consequences that the leasing contract and the rental contract have on the balance sheet could or can only be found in corporate accounting.
- The legal department of the Company may have had or has an overview over the entire contractual situation of the Company, including covenants in the loan agreements, but it does not have the expertise regarding the consequences of the contractual regulations on the balance sheet.

Summarizing the knowledge of the regulations relevant for the decision and the resulting consequences for the balance sheet took or takes place on the Management level. This means that in the present case, the conclusion of the contracts LCplan and RCplan, expedient when assessed in isolation, are stopped on the Management level since the indirect effects of these contracts became apparent when the knowledge of all involved departments was combined.

A retroactive change of these contractual regulations would not have resulted in a retroactive change of the accounting status as of the balance sheet date that was decisive for determining compliance with or violation of the covenants.

Given this incident, the Management increased the number of people working for the unit Internal Audit and extended the unit's responsibility to the implementation of a control systems and monitoring of similar cases. This means that, in the future, this unit monitoring these processes will have to review the mandatory implementation of procedural rules in the Company; this unit prevents the negative consequences for the Company that are described above. The unit 'Internal Audit' is directly subordinate to the Management and is always to be involved in the planning and drafting of contracts in the future.

9.6 Learning Outcome

9.6.1 CM Value for the Case Study

The CM Model introduces a structured procedure for solving the problem involving the Management, accounting matters, and contract law. The CM Model illustrates the interactions on an abstract level that contribute to a structured solution, if not making it possible in the first place. It becomes clear which reciprocal effects must be integrated in order to consider all aspects that are relevant for the case. Furthermore, the model makes it clear that all company-relevant information is ultimately only bundled on the Management level and an analysis of the effects of decisions on subordinate levels for the entirety of the Company can be made on this level only.

Concerning the specific case of drafting the lease and rental contracts, the CMM systematically leads to the solution of the following problems:

- What are the direct and indirect consequences a contract may have?
- How can the organizational rules immanent to the CM Model control these consequences?

The present case study highlights the importance of the CM Model:

- for the significant importance of a broad knowledge base that especially includes the indirect effects of contracts, and a high awareness of risks in drafting contracts, and
- for the impact of corporate management on the management of transaction.

9.6.2 Case Study Value for the Reader

The case study shows the reader:

- to what extent contracts can have scattering effects on areas that are not immediately associated with the contract,
- how accounting standards in general and different accounting systems in particular can impact contract drafts,
- how important organizational rules for obtaining knowledge are, and
- also, how important the need for implementing and monitoring processes is.

The conclusion of a leasing contract and rental contract were discussed as examples in this case. But that list is not conclusive. For example, continuing obligations or pending business may also result in liabilities on the balance sheet. Examples for continuing obligations can be delivery contracts with fixed sales prices, which may result in losses due to rising purchase prices, or for pending businesses, hedging transactions (e.g. against interest change risks or exchange rate fluctuations), which result in accounting risks caused by market developments.

The decision to use a leasing contract as an example was made in particular because there are considerable divergences in treating leased items for balance sheet purposes resulting from the different accounting systems HGB, IFRS, and US-GAAP, which leads to a complex accounting process that necessitates the involvement of corporate accounting and, where applicable, the external auditor, at an early stage.

Even for other contracts with effects on the balance sheet and with less complex facts, procedural measures still have to ensure that the effects on the balance sheets, e.g. the allowances for restitution as set out above, are also made known to corporate accounting before contract conclusion. Any resulting effects on the balance sheet will in turn have to be assessed in cooperation with the Management. Based on risk management, knowledge management, and corporate management, the CM Model therefore inevitably results in the need to implement corresponding procedural structures.

Appendices

Comparison of Leasing Concepts

Table 9.1 Comparison of leasing concepts HGB/IAS 17/IFRS 16—definition of leasing

HGB/Leasing decrees	IAS 17	IFRS 16
Assessment principle: *Economic assessment*	Assessment principle: *Economic assessment*	Assessment principle: *Control- and domination-based assessment*
Who is the beneficial owner of the asset/commodity	Who is the beneficial owner of the asset?	Who is controlling the asset?
Individual criteria: • Full or partial amortization • Non-cancellable basic lease period • Proportion non-cancellable basic lease period and standard service live • Contractual options Special leasing	Individual criteria: • Transfer of ownership • Term agreement Contractual options • Minimum lease payments Special leasing	Individual criteria: • Asset • Right of use • Freedom of disposition for Lessee • Rights of Lessor Special leasing

Differences IFRS and US-GAAP on 'Leases'

Table 9.2 Differences IFRS and US-GAAP (US GAAP (ASU 2016-02 'Leases'; ASC topic 842)

Subject	U.S. GAAP	IFRSs
Scope	Only leases involving property, plant, and equipment	Scope broadly applies to assets (with certain exceptions)
Lease classification	The classification of a lease depends on whether the lease meets certain criteria	The classification of a lease depends on the substance of the transaction. Specific indicators and examples are provided
Lessor accounting—sales-type leases	Specific criteria are provided for sales-type leases	No specific criteria are provided for sales-type leases
Present value of minimum lease payments	A lessee uses the rate implicit in the lease to discount minimum lease payments if this rate is known and lower than the incremental borrowing rate	A lessee generally uses the rate implicit in the lease to discount minimum lease payments
Leveraged leases	Special accounting is permitted for leveraged leases if specific criteria are met	No special accounting provided for leveraged leases
Recognition of a gain or loss on a sale-and-leaseback transaction	If the seller does not relinquish more than a minor part of the right to use the asset, a gain or loss is generally deferred and amortized over the lease term for an operating lease and over the useful life for a capital lease. If the seller relinquishes more than a minor part of the use of the asset, part or all of a gain may be recognized, depending on the amount relinquished	If the leaseback is a finance lease, the gain or loss is recognized over the lease term. If the leaseback is an operating lease, the recognition of a gain or loss differs depending on whether the transaction is established at, below, or above fair value
Sale-and-leaseback transactions involving real estate	There are specific requirements for sale-and-leaseback transactions involving real estate	The accounting for sale-and-leaseback transactions involving real estate is no different from that for sale-and-leaseback transactions involving non-real-estate assets

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The X Virus Case—Leeway for Contractual Steering of Hospital Treatment

10

Frank Wittig

Contents

F. Wittig (✉)
SRH Hochschule Berlin, Berlin, Germany
e-mail: frank.wittig@srh.de

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Abstract

The regulatory framework governing the treatment of patients in hospitals is quite complex and differs significantly from other industries insofar as the patient and the hospital have very limited influence over the design or the outcomes of the relationship between them. Through five different cases, the reader will be confronted with the questions whether the patient-hospital relationship can be qualified as a contractual relationship and whether it shows contractual elements, both allowing the parties to influence treatment and hospital stay. Furthermore, the reader will be familiarized with the unique aspects of patient consent, the patient/proxy-payor-provider constellation and bioethical principles that encompass the treatment from patient admission to patient discharge. The case study suggests that, although the CM Approach may not be suitable for steering the entire hospital stay of an individual patient, some of its elements can nevertheless be useful to highlight the possibilities for a compliant and efficient handling of the patient-hospital relationship.

Keywords	Hospital treatment contracting, informed patient consent, involuntary commitment, therapeutic privilege, medical prerogative, patient decree, duty-to-rescue, discharge management
Principle management topic	Legal compliance
Institution	Large, private
Subject of management	Compliance
CM process step	Plan
Management field	Compliance management
Contract type	Total hospital admissions contract, split hospital admissions contract

Editor's Note: For a full understanding of the CM Model's practical benefit for the case study, the reader may have to peruse at least sect. 1.4.4 and 1.4.5 of Part I. The keywords used above to characterize the area of contract application are explained in the key system preceding the case studies in Part II.

10.1 Challenge

10.1.1 Set of Facts

Hospital H is a private maximum care facility in Germany. Within its catchment area, patients of all medical and psychological conditions are to be regularly transferred and admitted to this facility for hospital treatment.

In order to combat a rapidly progressing neurodegenerative disease, Hospital H offers a recently introduced genetic therapy treatment for which a standardized patient consent form is handed out before treatment. To undergo treatment for this procedure, affected patients are considered as in-patients, meaning that he or she is admitted to the hospital for at least one overnight stay.

Although the genetic therapy treatment has received all regulatory approvals, it has just been determined that if the patient concurrently receives a vaccination against X virus—a common infection that is unrelated to the aforementioned neurodegenerative disease—the interaction between genetic therapy and the vaccine leads to the reactivation of the virus and hence outbreak of the disease. With an outbreak of X virus now occurring, the hospital has to quickly identify all patients who are in need of vaccination, and—even more urgently—those amongst the vaccinated who are about to undergo, or have already received, the aforementioned gene therapy.

For the patients of Hospital H, the following medical outcomes may materialize:

- For vaccinated patients who have already received gene therapy, only an immediate blood exchange with donated, untreated blood can have a reasonable chance of preventing an infection outbreak. As the virions are nevertheless released through the gene therapy, there is a high likelihood that affected patients will acquire long-term immunity to the virus.

- Patients who have not been vaccinated yet but still require the gene therapy must be kept under isolated, sterile conditions to avoid X virus exposure. This means that such patients won't be able to leave the hospital's intensive care unit for the duration of their treatment.
- Patients who have contracted X virus must be restricted to the hospital's isolation ward. If the outbreak continues, infected patients might need to be transferred to other facilities if the hospital's capacity is exceeded.
- If left untreated, X virus becomes neuropathic, leading to ever increasing nociception, meaning that the patient's sense of pain will become more and more extreme. Eventually, death occurs from physical exhaustion.

Consequentially, Hospital H's medical staff has to determine whether genetic therapy treatment may be continued for patients with suspected X virus infection. In this context, it also must be decided whether their patients have to be involved in the decision-making process for the course of treatment. Apart from Patient A, whose symptoms warrant a typical 'standard' care, the cases of Patients B through E will present the involved stakeholders with more complex decisions:

- Patient A: Having just turned 19, A is admitted to Hospital H with symptoms of food poisoning which are suspected to be caused by her spoilt birthday cake. A may be considered non-critical, since she neither suffers from the neurodegenerative disease nor requires an X virus vaccination. Patient A is covered by private insurance. Being a first-year medical student, she is very interested in observing healthcare from the patient perspective and wants to know how she can be involved in the decision-making process regarding her treatment.
- Patient B: A 27-year old female model has chosen Hospital H to have a rhinoplasty performed by an external cosmetic surgeon, External Surgeon S. Colloquially known as a "nose-job," rhinoplastic surgery aims to alter the shape, function, or aesthetics of the nostrils. General anesthesia is common for such a procedure. As Patient B is suffering from sleep apnea, an overnight stay in the hospital is required for observation after surgery. Upon admission, nursing staff note that the patient is developing symptoms of X virus infection. Hoping to still make the busy schedule of the renowned cosmetic surgeon, Patient B has signed the old consent form for the X virus vaccination which does not relate to the vaccination's interaction with the genetic therapy.
- Patient C: A 15-year old male high school student was admitted a few days ago and was confirmed to be in an advanced stage of the neurodegenerative disease indicative for genetic therapy. The patient's parents are in a legal custody dispute after the mother has joined the Cult of Spiritual Purity. Because of the cult's beliefs, the mother objects to any blood transfusions to her son. During a consultation with his doctors, the boy admits that he wandered off at night to explore the waiting area to the emergency room where he might have been exposed to X virus patients.

- Patient D: An approximately 40-year old female got into a severe fist fight with an X virus infected opponent. At the end of the rather bloody fight, the patient suffered a severe blow to the head with a baseball bat. Flown in by rescue helicopter, the emergency room crew immediately had to place the patient in an artificial coma to prevent brain damage. No form of identification was found on the patient's body upon admittance and it seems unlikely that the patient will regain consciousness for the duration of treatment in the hospital.
- Patient E: A 71-year old male is serving a life sentence in the county jail. After admission to the hospital, initial serological testing confirms X virus infection in an advanced stage. The patient, not willing to return to prison, objects to any further treatment and repeatedly states to hospital staff that he doesn't want to "slowly die behind bars."

The attending physicians who are in charge of each of the patients' treatments now have to decide whether they can follow common state of the art of medical practice, or whether they are bound by either mandatory regulations or by decisions made by the patients.

10.1.2 Operating Procedure

10.1.2.1 Author's Explanations

In light of the cases that are examined in the subsequent section, establishing the applicability of the CM Approach is quite challenging as modern healthcare systems are subject to a high regulatory density. Therefore, the role of a single hospital in general and the role of contracts in service provision in particular can only be understood within the entire context of stakeholder relationships, organizational settings and regulatory framework.

10.1.2.1.1 Stakeholders, Organizational Settings and Regulatory Framework

(a) **Stakeholder relationship:** To understand the patients' and the attending physicians' possibilities for determining the patient-hospital relationship, it is indispensable to be aware of the embeddedness of such a relationship within a wider network of stakeholders connected through performance and payment obligations which do not always go along contractual relationships.

Explanation: Healthcare System Stakeholders, in particular Financial Linkages
In most countries, the healthcare industry is curtailed by a unique legal framework that encompasses both the enormous social responsibility—tending to the physical well-being of the individual—and the massive costs of the healthcare system. To put this into context, according to the Deloitte 2018 Global Healthcare Outlook, combined healthcare spending is estimated to exceed US$ 8.7 trillion by 2020 (cf. [6], p. 7). Unlike in classical B2C transactions, provision of healthcare involves additional influential stakeholders, as visualized in the PAYOR and HEALTHCARE PROVIDER boxes in Fig. 10.1. Of course, regulatory authorities,

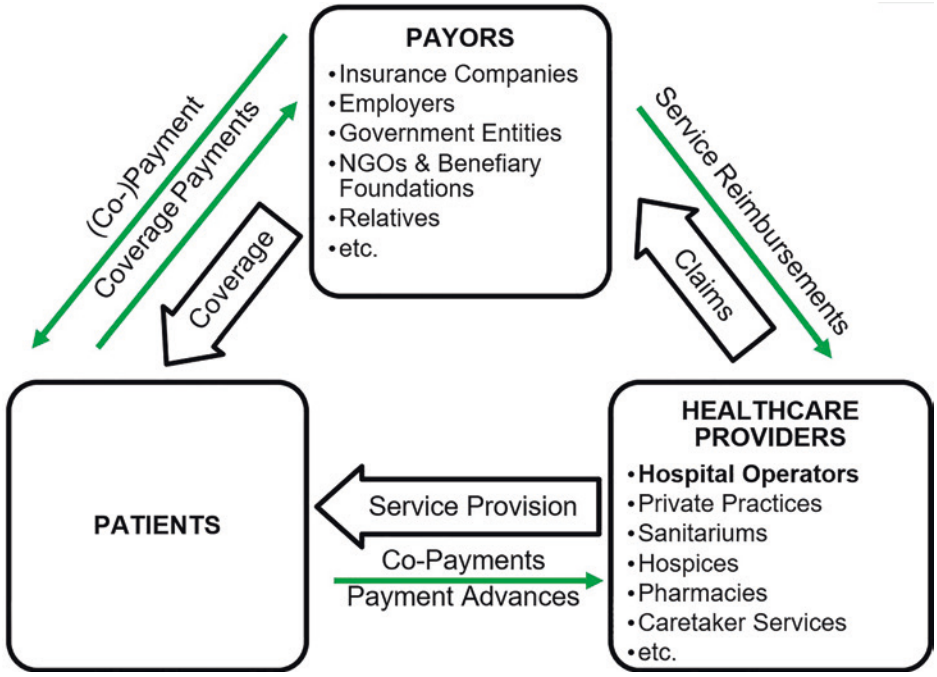

Fig. 10.1 Direct stakeholder relationships in the healthcare industry. (Graphic based in part on [13], p. 47)

associations, and lobbyist groups are also associated with each of these stakeholders, but not displayed here.

In Germany, patient treatment as well as reimbursement of the hospital operator is governed by law. The legal relationships between the main stakeholders that encompass service provision and compensation are thereby highly formalized in scope and structure. Cash flows affecting healthcare provider compensation are depicted by the green arrows in Fig. 10.1. Thus, the healthcare provider claims reimbursement from the payor, which in most cases is an insurance company. The patient in turn makes coverage payments to the payor for financially sustaining healthcare provision to him or her. If covered by a private insurance plan, the patient is often also obliged to make advance payments or co-payments to the healthcare provider before being entitled to claim reimbursement from the payor.

If this constellation were to be translated to the "classical" B2B or B2C interpretation of the transaction, it would correspond to mandatory law curtailing of the terms of contract formation, (contract) service pricing, and contract termination. These unique factors must be respected in order to comprehend how a contract may be used as a steering instrument in hospital treatment.

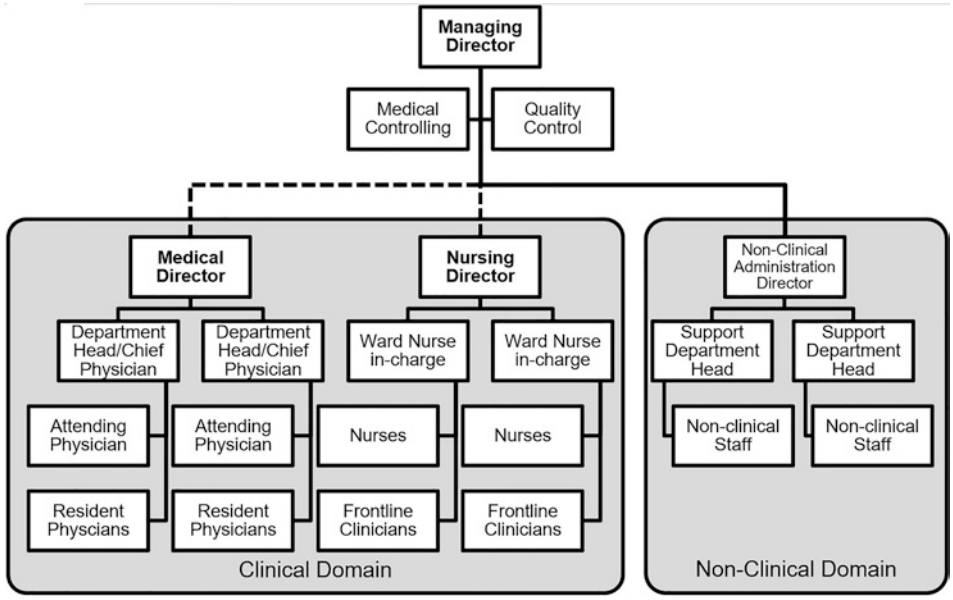

Fig. 10.2 Abstract organogram of a hospital

(b) **Organizational settings:** Furthermore, the specifics of decision-making within a healthcare-providing institution must be taken into account. As the patient-hospital relationship is essentially governed by legal stipulations and bioethical considerations, corporate management is not fully applicable in the context of this case study. Indeed, keeping in mind the unique organizational structure of hospitals, the reader should not expect a classical managerial hierarchy wherein the decision-making managing director (traditionally with a background in business administration) has the right to direct all the activities of subordinate employees. Instead, attending physicians are to conduct their treatment free from non-medical interference, as depicted in the vertical domain divider in Fig. 10.2 above.

Explanation: Organizational Domains in Hospitals

A hospital can commonly be divided into a clinical domain, in which substituent employees are directly involved in the provision of medical care, and a non-clinical domain in which employees act in supportive roles such as in billing, IT, maintenance, etc. Executive power over physicians, as distinguished for private businesses by the German Works Constitution Act (§5 III BetrVG) into functional directive and disciplinary authority over staff, is mostly vested in the position of the medical director.

Within the clinical domain, physicians have functional directive authority over nurses. It should also be considered that clinician teams are in constant flux and are often adapted in staff membership depending on the individual case or procedural

needs. This poses a challenge to the understanding of one's individual role with regards to non-clinical duties, such as contract management work.

Consequently, the clinical domain rarely gets recommendations from outside its domain, f.e. by medical controlling as to how resource utilization is to be optimized; however, direct interference on a step-by-step basis in the medical treatment of an individual patient is generally not possible under the purview of medical prerogative (as further detailed in Sect. 10.4.1.2).

The intended separation of the clinical domain from interference by non-medical decision makers can, under specific circumstances, result in direct conflicts in philosophy: Business-related enterprise goals (such as striving towards profitability, or maintenance of business partner networks) might not extend into clinical departments, where the Hippocratic Oath likely will be the dominant philosophy. Depending on the degree of organizational separation in a hospital, one of the main promises of the CM Approach—interdepartmental alignment affected by a contract—might stop at the medical ward's doors.

(c) **Regulatory framework:** Finally, a vast legal framework pertaining to the patient's hospital stay as depicted in detail in Fig. 10.3 must be taken into account, spanning from civil and public law, through procedural agreements and framework contracts made in self-governance on the association level up to occupational regulation.

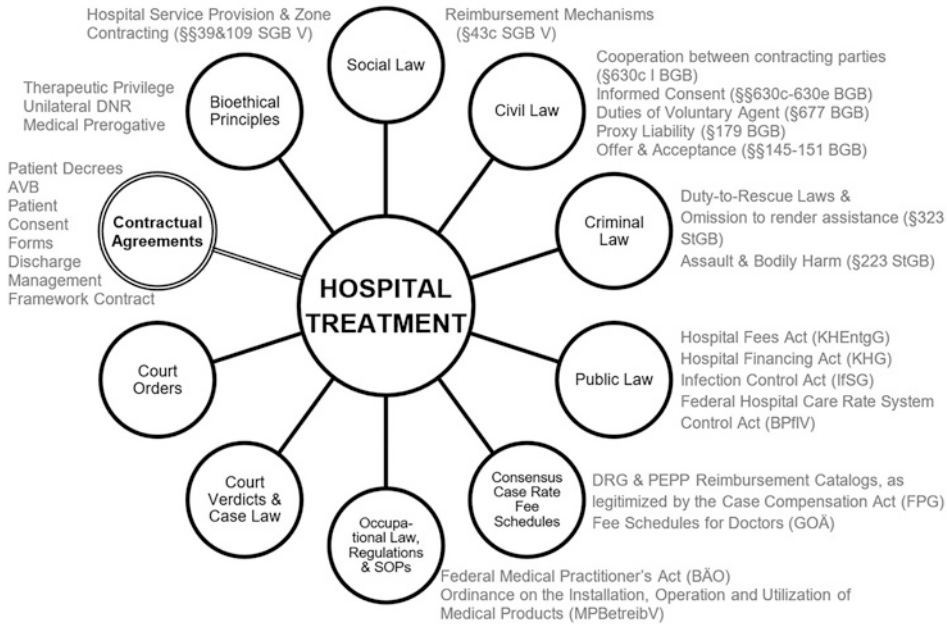

Fig. 10.3 Excerpts of the legal framework governing hospital treatment in Germany

Designed to guarantee accessible, affordable and quality health care, these legal instruments constitute a dense network of mandatory rules (*ius cogens*), which means that contractual stipulations or instruments may not vary the substance and philosophy of such provisions. Bioethical principles take an intermediate role within this framework since they unfold quasi-binding effects. This statutory framework can also involve further legal instruments such as court verdicts and court orders, adding to the complexity and high degree of differentiation of the German health care regulatory system.

The observance of this network of rules goes beyond the reach of classical legal compliance in companies and offers little leeway for the implementation of the will of the individual parties through contractual agreements regarding the type, duration and execution of treatment as well as service renumeration. Therefore, even if a contractual relationship exists between hospital and individual patient, it needs to be determined whether contractual management mechanisms, or variations thereof, are indeed possible given the extensive regulatory framework governing such a relationship.

10.1.2.1.2 Relevance of a Contract for the Patient-Hospital Relationship

In order to determine the general applicability of the CM Approach, we must assess whether two fundamental requirements are met: First, a contractual relationship exists between the major stakeholders of the transaction and the involved parties have a certain degree of freedom to modify elements of the contract. Second, the organizational framework of the service provider is flexible enough, such that an individual contract may influence the interactions between the former's business units or departments. The remainder of this section will explore whether the patient-hospital relationship—in its entirety—can be encompassed by a contract.

As will be shown hereunder, the patient-hospital relationship does not always fall under civil law and hence, the realm of contracting, but can instead be interpreted through the entitlement concept set forth by social law. Within this section, these opposing legal philosophies are exemplified by the German legal system. However, some references to other countries are made in order to provide an international context for the overall chapter. In Germany, the following approaches to the nature of the patient-hospital relationship can be distinguished:

(a) Proponents of the **social law interpretation** of relationship argue that no contractual relationship exists between patient and treatment provider, as the duty to perform treatment according to medical standards is governed by the Social Code V (SGB V) in Germany. Essential to this interpretation is a series of verdicts by the German Federal Social Court *(Bundessozialgericht)* [42]. In addition, physicians do not have a direct claim for monetary compensation from patients covered by statutory insurance (which corresponds to more than 90% of the German population), as the latter is to guarantee basic treatment provision *ex officio* by law. In many respects, a German statutory type insurance has many similarities to 'public insurances' of other countries (such as the Medicaid system of the United States, or the British NHS) so the

terms are used interchangeably in this section for the sake of simplifying the distinction from private insurance providers. In fact, the adherence to medical treatment standards and performance of treatment services to covered patients (essentially the service scope in a treatment contract) is set forth by the physician's obligation to the Association of Statutory Health Insurance Physicians (*Kassenärztliche Vereinigung*, as defined by §95 III SGB V, cf. [22], pp. 113–116). Consequently, it is suggested that the patient-hospital relationship is governed by a **public law special relationship**, and the physician (or employing institution) solely makes monetary claims to the patient's payor; civil proceedings only become applicable in cases of medical malpractice, cf. §76 IV SGB V. For the provision of treatment, it can thus be argued that no direct bargained-for-exchange exists between patient and hospital and therefore, one of the essential requirements of a contract is not applicable.

(b) Proponents of the **civil law interpretation** of the patient-healthcare provider relationship maintain that the provision of treatment is still governed by a civil law obligation. Essentially, it is made on the basis of the legal relationship between insurance and health care provider, with patients as incidental beneficiaries as explained below.

Explanation: Association Membership and Framework Contracts

The legal relationship between HEALTHCARE PROVIDER and INSURANCE does not follow a contract directly concluded between these parties, but rather emerges from their association membership and FRAMEWORK CONTRACTS as depicted in Fig. 10.4.

Both the scope of healthcare services and their integration into universally applicable fee schedules is in the hands of stakeholder associations. Business entities and practitioners accept these collective agreements through their association membership (§115 SGB V, §18 I KHG) and can therefore only indirectly influence the contents of these service-defining framework contracts through their association representatives. Thus, the provision of treatment by the hospital as well as the reimbursement by the insurance, which are delineated in the lower part of Fig. 10.4, are governed by framework contracts made on a collective basis as shown in the upper part of the figure, i.e. between the health insurance associations as well as the Association of Statutory Health Insurance Physicians, certain occupational guilds, or the German Hospital Association.

Individual insurance-physician contracts, as f.e. commonly encountered in highly individualized form in the United States, were abolished through the German Healthcare Service Structure Reform Act of 1993 *(Gesundheitsstrukturgesetz)*. Since a contract towards an intended beneficiary is not created, as specifically with regards to §328 German Civil Code (BGB) (cf. [22], p. 114), there is no specific, steerable linkage—which is essential in the purview of the CM Approach—between individual patient and individual healthcare provider.

(c) As medical malpractice is governed by civil law, another school of thought argues that patient and healthcare service provider still perform an **acceptance of the**

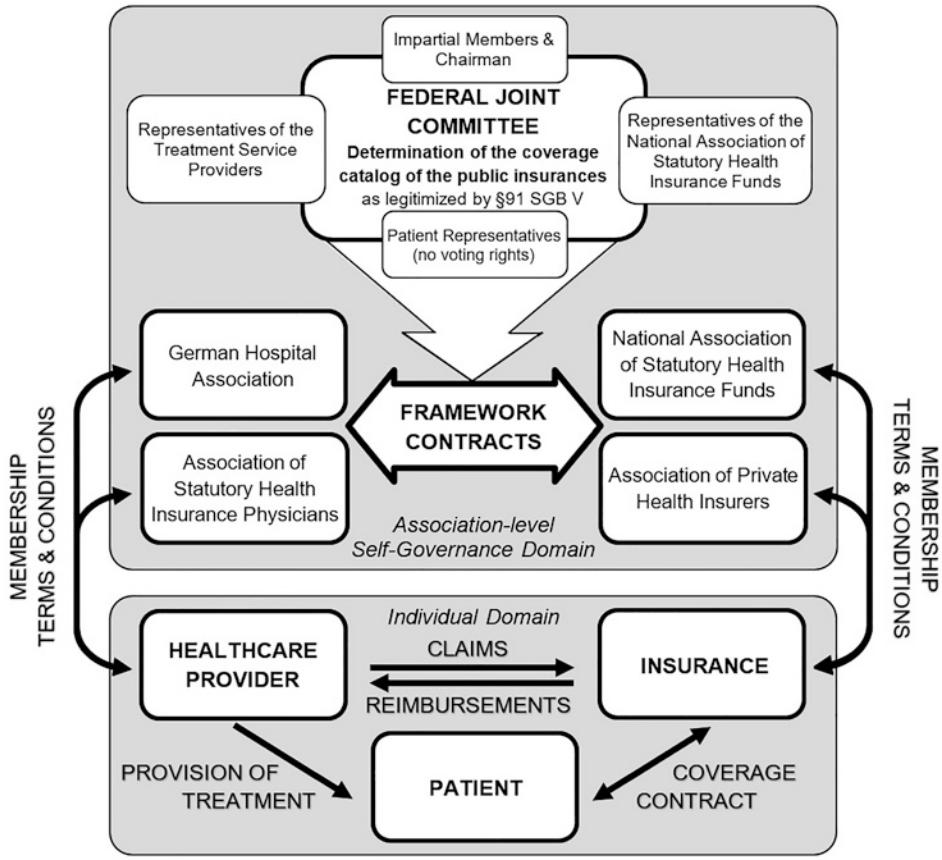

Fig. 10.4 Legal relationships between healthcare industry stakeholders in Germany

treatment obligations and risks which in turn is analogous to another pillar of private contract law, the meeting of the minds.

(d) Likewise, some proponents (cf. [32]) argue that **social law does not explicitly prohibit the drafting of an individual contract** between treatment provider and patient regardless of the extensive regulation through the complex matrix of framework contracts and membership agreements between individual treatment provider, insurer, their respective umbrella associations and even the Federal Joint Committee *(Gemeinsamer Bundesausschuss)*. Formalized by §91 SGB V, this latter panel independently approves the procedures to be covered by statutory health insurances in Germany. It essentially defines the medical treatment service catalog of all public health insurance plans in Germany and, hence again, the subject, nature and scope of any such treatment contract.

Lastly, the steering of the treatment of the patient needs to be addressed in the context of the contract's relevance for the patient-hospital relationship. Medical treatment contracts are recognized as an amalgamation of service, rental, and sales contracts (cf. [29], p. 21).

Therefore, they do not oblige the healthcare provider to produce a specific treatment outcome but instead to perform medical practice at *lege artis,* meaning that they must follow accepted medical standards and that deviations in 'service quality' are illegal. Defining the resulting contractual deliverables becomes challenging depending on the respective nature of the treatment.

Explanation: Provision and Outcome of Treatment

According to German contract law, hospital services can be provided under a works contract (*Werkvertrag*) in accordance with §631 BGB or a service contract (*Dienstvertrag*) according to §611 BGB. In the first case, the service provider is obliged to produce a specific treatment outcome, whereas in the latter case services are to be delivered in compliance with industry best practice (*lege artis*). For treatment with medical indication, the hospital provider offers services to treat the patient (usually within the purview of a social law/best-practice guideline, such as SGB V §27 et seq.), but success of the treatment ('curing the patient') or attainment of a specific physiological key performance indicator ('this pain has to be gone within two weeks') is rarely contractually stipulated. Therefore, hospital admission and treatment contracts are considered as service contracts and, consequently, may be litigated solely along the lines of medical malpractice or negligence, but not for breach of contract due to default in performance.

In this regard, the hallmark case of *Hawkins v. McGee* (1926) serves as a classic example from US common law of how expectation damages may be determined from a failed medical procedure towards which a specific performance was contractually defined. Here, the express guarantee to restore a crippled hand to a "hundred per cent perfect hand or a hundred per cent good hand" through skin graft surgery was expressly promised but not met by the treating physician (cf. [45]).

In line with this reasoning, treatment contracts are also not designed to conclude upon a fixed duration of treatment and may be considered as open-ended in duration until the determination of conclusion of treatment by the responsible physician, or the retraction of informed consent by the patient (cf. [28], p. 73–74).

10.1.2.1.3 Remuneration for Medical Services

In general, hospital service reimbursement may be categorized into treatment costs (medical and psychiatric care, pharmaceuticals, etc.) and ancillary costs (accommodation in room, food, comfort services like Pay-TV or internet access, drafting of medical expertise/expert witness statements, translations, etc.) ([21], pp. 230–236, [15], p. 101). Hospitals may offer ancillary services as long as they have the capacity to do so without

impairing the provision of ordinary treatment. In Germany, however, §17 I (1) KHEntgG serves to prevent physicians from only focusing on patients who have booked additional services (cf. [21], pp. 236–237).

While the complexity of medical service remuneration easily exceeds the scope of this case study, it suffices to state that, in Germany, monetary compensation for medical procedures is legally mandated to be the same regardless of the institution or type of payor.

Explanation: Pricing Freedom for Medical Treatment Services

In its most unregulated form, the hospital is completely at liberty to charge the patient or his or her payor any price it wants. As a result, such Pay-for-Performance models—or even Pay-before-Performance models—materialize. For example, within the United States of America, the Emergency Medical Treatment and Active Labor Act (EMTALA) governs that 'participating' hospitals must provide emergency treatment to anyone seeking treatment. Only private hospitals that do not accept payments under the Medicare program are allowed to refuse such service. By nature, both models may entail a degree of pricing intransparency (certain patient groups might be receiving different pricing conditions than others, (cf. [35]) as well as an incentive to conduct and bill more treatment procedures than might actually be medically necessary. These factors contributed to the abandonment of so-called free hospital financing in Germany in 1936. On the other side of the spectrum, countries like Germany completely regulate the reimbursements allocated to hospitals along a point system that strictly governs the compensation per diagnosis-related group (DRG) and also varies depending on the time between hospital admission and discharge of the patient, cf. §17b KHEntgG. A committee consisting of representatives from the German Hospital Federation (*Deutsche Krankenhausgesellschaft*) as well as from the statutory and private insurers negotiate to determine the case rate plans for medical and psychological treatment (*DRG & PEPP Entgeltkataloge*). This arrangement is legitimized by § 87 I (1) SGB V and is the basis for all treatment reimbursements to hospitals in Germany.

Consequently, uniform pricing is legally mandated for all medical and psychiatric procedures offered by a hospital, regardless of a patient's insurance coverage or legal status. This concept is the underlying hallmark of the German Hospital Fees Act, *Krankenhausentgeltgesetz (KHEntgG)*, as well as §109 (4) SGB V (cf. [15], p. 8). Therefore, hospitals are only at liberty to control revenue with regard to ancillary costs or by performing elective medical procedures (such as cosmetic surgery) that do not fall within the purview of regular healthcare provision. Overall, this in turn means that there is essentially no basis for negotiating pricing terms between hospital and patient. Ancillary costs are communicated to the patient via fee schedules and are likewise considered as tacitly accepted upon admission.

Indeed, as described by Rehborn, hospital treatment in Germany that is covered by a statutory health insurance plan does not fall within the purview of contract law

due to the particular superseding influence of social law, essentially leading to a public law special relationship (cf. [26]), p. 257). A non-healthcare related example would be a labor contract between a prison (and therefore the justice system) and a prisoner. Such a special legal relationship commonly encompasses an affirmative service provision or duty by a state or public authority to an individual, the conditions of which are essentially unalterable by the subordinate. Still, for elective procedures at a hospital, separate contracts may be signed between the patient and an authorized employee of the hospital.

Nevertheless, with an increase in medical tourism, the pricing flexibility of an individual hospital will obviously play a significant role in competing on the growing global market. Understanding the different legal backgrounds and expectations of international customers is likely to become a requirement to the expertise of the internationally-oriented hospital operator.

The pricing of services must be distinguished from payment procedures, which have already been addressed briefly under 10.1.2.1.1 above. As depicted in Fig. 10.1, the reimbursement of the hospital's services is performed by the patient's payor. However, German social law also provides the option for a patient to initially cover the treatment expenditures by him- or herself and later make claims to his or her statutory health insurance, similar to a private insurance plan. In such a scenario, the contractual mechanisms of the German Patient Rights Act come into effect again. Furthermore, there is also no dispute on the contractual nature of the legal relationship when an external doctor uses a hospital's resources for treatment under his or her authority as further explained in Sect. 10.4.2.3.

In either case, the medical professional is required to adhere to medical diligence—regardless of whether the patient is covered by a statutory health insurance, or whether the treatment is financed by him- or herself. Consequently, any steering of the latter's performance, as f.e. through detailing clauses of a treatment contract, is superfluous as such performance requirements are already stipulated by law.

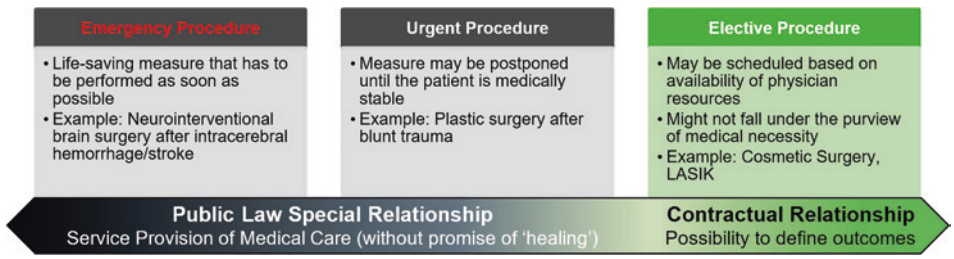

Fig. 10.5 Types of medical procedures in relation to regulatory framework

10.1.2.1.4 Summary of Author's Explanations

In Germany, the patient's hospital stay is impacted by a vast legal framework that remains irreconciled as to whether a treatment provider is linked to the patient through a contract. For determining the legal basis of the patient-hospital relationship, the type of procedure the patient is undergoing must be considered, as outlined in Fig. 10.5.

While emergency procedures and urgent procedures pertain to the domain of public law and are based on a public law special relationship, elective procedures such as cosmetic surgery or LASIK are executed following contractual obligations. However, even where the German Patient Rights Act does provide contractual mechanisms for the patient-hospital relationship, an actual steering effect that covers the entire treatment process is difficult to discern: Medical treatment itself quickly becomes the domain of the physician due to medical prerogative (see Sect. 10.4.1.2); therefore, interference of a superordinate non-clinical management level in treatment processes is uncommon on the operative domain. Similarly, the scope and definition of service quality is relegated to the framework contract domain at the association level, as depicted in the upper part of Fig. 10.4.

Since §§ 17 I (1) KHG and 630a (z) BGB declare that remuneration of the hospital has to be the same for all patients, there is no freedom of negotiation (an essential hallmark of the CM Approach) possible on this monetary matter either. In conclusion, while the negotiation and drafting of a detailed contract is possible, there is no particular need for it since any treatment process worthy of steerable control is governed by non-contractual regulation already.

While treatment as a whole may only facultatively be defined in something like a comprehensive treatment contract, other elements of the patient's stay in the hospital, in particular non-treatment services such as accommodation or internet-access, can without dispute be handled by contracts. This assumption is analyzed further in the annex to this chapter.

10.1.2.2 Reader's Tasks

After having gained a general insight into the organizational and legal framework concerning the healthcare industry, the reader should now reflect on the following questions, which, in a more specific form, raise the issue of the physician's and the patient's options to determine hospital treatment. He or she is invited to take the position of the physician in charge working with Hospital H and to answer the following questions in view of Patients A through E:

Patient A:

Q1: What are Patient A's options with regard to his treatment? (Level of Difficulty: Medium)

Q2: Which mandatory rules do Patient A, Hospital H, and the hospital's employees have to comply with? (Level of Difficulty: Medium)

Patient B:

Q3: What are the legal relationships of Patient B with her treatment-providers? (Level of Difficulty: Medium)

Q4: Which treatment and services will Patient B obtain depending on the severity of her X virus infection? (Level of Difficulty: Medium)

Q5: Under which conditions do the external physician's or Hospitals H's obligation to provide treatment end? (Level of Difficulty: Medium)

Patient C:

Q6: Who is entitled to make decisions with regard to Patient C's treatment? (Level of Difficulty: Low)

Q7: Assuming that Patient C's mother retracts her consent to the blood transfusion treatment on religious grounds, how could a reasonable course of treatment be justified? (Level of Difficulty: Medium)

Patient D:

Q8: Which decisions must the attending physician make with regard to Patient D's possible intentions? (Level of Difficulty: Low)

Q9: Who is obliged to pay for Patient D's treatment? (Level of Difficulty: Low)

Q10: How can Hospital H proceed if Patient D remains comatose or needs long-term care? (Level of Difficulty: High)

Patient E:

Q11: Has Patient E produced a valid patient decree? (Level of Difficulty: High)

Q12: What are the attending physician's options with regard to Patient E's patient decree? (Level of Difficulty: High)

Q13: Could a contract lead Hospital H out of the dilemma? (Level of Difficulty: Medium)

Where necessary, consult the **Compendium on the Formation and Implementation of Hospital Treatment Contracts** displayed in the annex of this chapter.

10.2 Decision-Making Process

The cases introduced in Sect. 10.1.2.2 aim to highlight specific scenarios faced by the attending physicians of a German hospital and their patients: a 'regular' stay of a privately insured patient (Patient A), a shift of physician responsibility during a cosmetic surgery (Patient B), a legal proxy dispute with regard to an adolescent patient (Patient C), the entire provision of hospital treatment to an incapacitated patient leading to her discharge to subsequent care (Patient D) and, lastly, the unique bioethical dilemmas faced if a convicted prisoner under treatment essentially decrees assisted suicide (Patient E).

10.2.1 Patient A

10.2.1.1 Identification of Decision Options

Patient A is covered by a private insurance, is willingly admitted to the hospital, legally capable, and is to undergo a standard treatment procedure within the purview of the hospital's designated service catalog under the responsibility of a physician regularly employed by the hospital. From this set of facts, it can be assumed that Patient A would be admitted using a total hospital admissions contract, and would consequently have to pay treatment costs in advance before her private insurance provider would reimburse her. During treatment and subsequent observation during her recuperation, neither evoking of therapeutic privilege by the attending physician, nor need for unilateral initiation or termination of treatment is assumed. Similarly, no patient decrees that would impede treatment provision are presumed to be in effect.

Q1: What are Patient A's Options with regard to his treatment?

Assuming that the hospital has elected to be open for patients and not divert them to other facilities, the basic scenario begins with the patient making the choice to be admitted to Hospital H and undergo initial diagnosis. Assuming that there is no state of emergency, the hospital has little reason to deny admission to Patient A; therefore, contract formation will not be debated at this point. Likewise, as clinical departments commonly act relatively independently from the clerical unit counterparts, it is hard to imagine that clinical decisions would be postponed due to a missing preparatory step made in the non-clinical domain.

After admission, qualified medical staff are to provide the patient with the results of the initial diagnosis and the risks and benefits of any suggested treatment alternatives to her food poisoning in a patient-physician conversation. This way, the patient gains the decision basis for providing informed consent as detailed in Sect. 10.4.1.2. Alternatively, providing no reconciliation is possible, Patient A could, as an alternative, only explicitly request discharge.

Patient A therefore solely needs to make the decision whether or not to go ahead with the treatment plan as explained by his attending physician. For this, she may make necessary inquiries, but steering or detailed control over minute aspects of treatment steps are within the professional discretion of her attending physician. Patient A is to **cooperate in a fashion conducive to the treatment goal**, the motive of which is defined by German civil law (§630c BGB). The only way to refuse individual treatment aspects, f.e. accepting gastric lavage (stomach pumping), but refusing injections, would be for her to retract informed consent to the overall treatment procedure. If the attending physician is not able or willing to provide an alternative treatment procedure (additional costs and risks thereof would have to be communicated in an additional informed consent conversation), the patient once again only has an all-or-nothing decision option. As a last alternative, Patient A may also demand transfer to a different attending physician. If the latter is not employed by the hospital, a split hospital admission contract would be formed. The direct stakeholders in both transaction scenarios, as well as superordinate influencers over them, are depicted in Fig. 10.6.

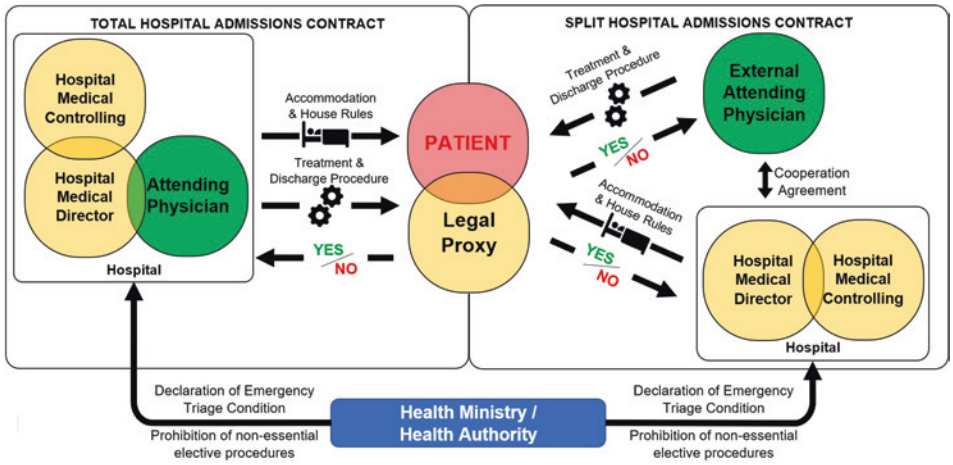

Fig. 10.6 Decision-maker influence on hospital treatment of a privately insured patient

In parallel to regular treatment, Patient A may also elect to book ancillary services as addressed in Sect. 10.1.2.1.2, a transaction provided under normal contract law.

Upon conclusion of the medical service regimen, treatment is deemed complete by the attending physician. If Patient A doesn't object to the physician's verdict, she has to then be informed about the discharge management procedure and the associated subsequent steps that are organized by her attending physician or the nursing director of the hospital. To this, Patient A may elect to either accept or refuse it in similar fashion to an informed consent decision. The hospital has the option to use a standardized contract to formalize the acceptance to the discharge process as well as for the forwarding of patient data to the follow-up service providers.

Q2: Which mandatory rules do Patient A, Hospital H, and the hospital's employees have to comply with?

From a compliance perspective, the procedure and **conduct by clinical staff** is governed by civil, criminal, social, data protection, and/or occupational law. Violations thereof might result in respective court proceedings, often with the patient as plaintiff. Furthermore, non-compliance of a healthcare employee entails the risk of admonishment by the respective professional association, such as the German Medical Association, which may declare penalty charges, or—in the worst case—a determination of unfitness for occupational capability. Non-adherence by medical staff to standard operating procedures (SOPs) issued by the hospital might have labor law consequences, or internal disciplinary actions as governed by the individual employment contract with the hospital.

For the hospital as an institution, persistent inability to provide the service scope set forth in the hospital zoning plan might result in a future reduction of the hospital's catchment area or even the entire removal of the institution from the state zoning recognition.

Similarly, mishandling patient data might result in the punitive measures for the hospital set forth in the national (§§43–44 BDSG for Germany) or EU data protection laws (Art. 83 IV–V GDPR) and even criminal proceedings if a healthcare professional willingly discloses confidential patient data (§203 I (1–2) StGB). On a case-specific level, suspect insurance claims by the hospital to the patient's payor might result in a case audit which, as detailed in Annex 10.4.3.3, often results in a reduction of reimbursement. Furthermore, the hospital might risk adverse proceedings by the German Hospital Association, or third-party certification or accreditation agencies (should the hospital have elected to use the latter's services).

When considering the **compliance perspective for Patient A**, it can be seen that she has limited options to influence detailed steps of the treatment other than retracting consent to the overall treatment or the subsequent discharge management. From a liquidity perspective, Patient A might have limited bargaining power, because, as depicted in Fig. 10.1, she is likely to advance the treatment costs for her payor (the private insurance) and therefore could effect a faster, direct cash flow to the hospital, at least in comparison to the reimbursement pathway by statutory health insurances. However, just like patients covered by statutory insurance, Patient A's influence to immediately withhold payment to the hospital is marginal, as her contractual relationship to the hospital is still governed by the legal framework set forth in the German Patient Rights Act (in particular§630a I BGB). This correspondingly obliges her to make the agreed upon payment. Any contrary action would place her in default pursuant to the respective sections in the AVB model contract (§5, regardless of whether the treatment is governed by the total hospital admissions contract, or split hospital admissions contract version) that is issued by the German Hospital Federation.

10.2.1.2 Interim Outcome

As can be seen from this case of exemplary treatment service provision, the majority of the 'transaction' is governed by legal statutes and—with the aforementioned exceptions of ancillary services, association membership, or employment—does not require the redundant definition or steering by an all-encompassing contract as addressed in Sect. 10.1.2.1.2. This is mirrored in the fact that contractual documents—if handed out at all to non-privately insured patients—mostly cover the identification of the transaction stakeholders and modalities of payment for ancillary services.

Nevertheless, hospital routine thrives on the diversity and unpredictability of medical conditions and the stochastic processes involving multiple stakeholders with sometimes differing, if not fluctuating, interests. While a contract might model ordinary treatment provision in a relatively straightforward fashion, the reality of the hospital ward comprises a vast variety of exceptions that make up the dynamics of clinical pathways. The following sections aim to show some divergent cases wherein the classification, performance and termination of treatment will challenge the reader's understanding of contractual steering in actual execution.

10.2.2 Patient B

10.2.2.1 Identification of Decision Options

From the set of facts, it can be determined that Patient B is undergoing an elective procedure that is to be performed by an external surgeon from outside the hospital. Whereas the rhinoplasty likely will be handled contractually, complications arising from the treatment of the X virus symptoms might fall under the regular purview of hospital (emergency) treatment, thereby making the relationship between the parties shift over to that of a public service special relationship.

Q3: What are the legal relationships of Patient B with her treatment-providers?

Assuming that, as in most cosmetic surgeries, the patient has to negotiate and cover elective treatment expenses herself, no direct authorization from an external payor, such as an insurance company, has to be acquired for the rhinoplastic procedure. Similarly, hospital selection is described to have been made under the free choice of the patient.

Due to the required post-surgery observation, B is considered an in-patient. As such, a split hospital admissions contract should be set up with Patient B as the service recipient and Hospital H, in conjunction with the External Surgeon S, as the service provider. Responsibility to establish informed consent for the rhinoplastic procedure would lie with S.

In parallel, the external physician has to establish contractual agreements with the hospital in order to arrange and schedule access to the latter's facilities. Otherwise, the surgeon would not be able to meet his contractual obligation to provide the rhinoplastic procedure to B.

Q4: Which treatment and services will Patient B obtain depending on the severity of her X virus infection?

The hospital's part of the service provision with regards to the rhinoplastic procedure essentially encompasses the providing of its facility and ancillary resources, such as accommodation, access to the operating theater, medical equipment, anesthesia gases, and the sterilization of equipment that the external surgeon will require. In parallel, the hospital might offer comfort services such as Pay-TV or valet parking. As described in Sect. 10.1.2.1.2, associated pricing would be communicated via fee-schedule and are essentially non-negotiable for the patient.

For the beginning of the case, treatment authority lies with the External Surgeon S and not a representative of the hospital. Consequently, the contractual relationship to the hospital would fall under the purview of a **split hospital admissions contract**. Furthermore, considering that Patient B likely has certain expectations from the cosmetic surgery procedure, an (at least) rudimentary definition of the treatment outcome of the rhinoplasty might even be defined in the contract. In this regard, the Hospital H, from its risk management perspective, might solely have to confirm that the external physician has valid licenses to perform the procedure and that its equipment is in compliance with clinical standards.

Upon the suspicion of X virus infection, the relatively straightforward elective treatment case becomes intertwined with the infection control law aspects of emergency medicine. Assuming that the External Surgeon S will not have made the diagnosis himself and would not continue to stay around to treat a contagious disease, a hospital physician would assume the role of either an additional or a new attending physician. The split hospital admissions contract would therefore become supplanted with a **total hospital admissions contract**. The hospital physician would have to take the necessary steps to obtain informed consent from Patient B for subsequent treatment that aims to achieve immunity of Patient B against X virus. While informed consent is primarily based on a cooperative dialogue between patient and physician, this process can be supplanted by the patient consent form mentioned in the set of facts. Nursing or administrative staff would have to provide the most current version of the form and make it available to the right doctor. Usage of only the old form that doesn't mention the risk of adverse drug reaction to the gene therapy against the neuropathic disease could still be used at this time if the hospital staff can assure that Patient B won't receive this particular treatment. As the German Patient Rights Act and associated case verdicts place emphasis on the conversation between patient and the qualified attending physician to establish informed consent (wherein adverse drug interaction risks must be explained anyway), the form should not be relied upon solely and may only act as a supplementary instrument of knowledge management. It is also likely that, due to specialization, the hospital physician is more experienced in immunological treatment details than External Surgeon S, thereby making the former more qualified with regards to §630h IV BGB (cf. [26], pp. 270–271) to act in such a role. However, in light of the case history—since S was the professional who essentially brought Patient B to Hospital H—he might still be involved in the handing over and explanation of the consent form for managing his business relationship to her.

A change in the attending physician has the consequence that regular hospital care is being provided and the pricing control of the German Hospital Fees Act (KHEntgG) comes into effect. The hospital now has to identify Patient B's payor, i.e. her regular health insurance provider needs to be determined and the standard tripartite stakeholder relationship depicted in Fig. 10.1 is established, as with all 'regular' patients. For the continuation of this case, it is inconsequential whether B is covered by public or private insurance. Patient B, however, runs the risk of incurring opportunity costs for missing her original rhinoplasty appointment with her external surgeon; examples could be travel expenses claimed by S for a new appointment, or the costs billable to S by the hospital for having already made resources available at the time of the initial surgery date. Certainly, she will have to pay the accommodation costs of the hospital prior to her positive X virus diagnosis and the hospital will directly collect these charges from Patient B. According to §630c iii BGB, the hospital is obliged to inform the patient, should the complete cost coverage of a treatment procedure be in jeopardy (cf. [16], p. 181).

As Patient B has already signed the old consent form for the X virus vaccination, it can be assumed that informed consent has been established. From the set of facts, one can presume that the patient is still lucid and legally capable of understanding an updated

consent form. Therefore, the risk of the adverse reaction should Patient B ever need the gene therapy in question would be communicated directly and of course via her discharge letters including her medical records.

Should Patient B, however, refuse to sign the updated form, doctors in conjunction with healthcare authorities would have to determine whether her condition warrants either a forced vaccination or a transfer to an isolation ward. If so, Patient B would have to abide by such procedures in accordance to the Infection Control Act (§25 IfSG). In either case, performance of the original rhinoplasty surgery becomes highly unlikely: From a scheduling perspective, the patient runs the risk of losing her operation slot in the External Surgeon S's 'busy schedule'. From a medical and cost perspective, performing a surgery in septic conditions entails huge operational challenges (cf. [33]) and likely will vastly exceed the budget agreed upon for a simple rhinoplasty (cf. [4]). This would have the consequence that the cosmetic surgery likely won't be performed as intended in the original elective procedure contract between Patient B and S.

Q5: Under which conditions do the external physician's or Hospitals H's obligation to provide treatment end?

In the most straightforward scenario, Patient B consents to being vaccinated against X virus by a physician employed by the Hospital H who, after completing the vaccination (with the outcome of effecting immunity against X Virus in Patient B), discharges her back to the responsibility of the External Surgeon S. Shortly afterwards, S will perform the rhinoplastic surgery. Once S clears Patient B for discharge after an uneventful post-surgery observation, the split hospital admissions contract ends. The risk concerning the possibility of causing the adverse reaction to the gene therapy should be listed in the discharge letter of the hospital if only the old version of the X virus vaccination consent form was used. Providing the surgery outcome does not severely fall short of medical *lege artis*¸ or possible minimum deliverables S might have promised in his contract with B (such as aesthetic targets conducive to B's modeling career), Patient B would be obliged to compensate S as contractually agreed upon. S would similarly be obliged to compensate the hospital for utilization of its resources.

Should Patient B's X virus treatment be prolonged and cause her to miss her surgery appointment as previously described, S and B would have to renegotiate the contract and the compensation of liabilities S has to the hospital. With regards to the legal relationship between Patient B and Hospital H, discharge authority lies with the treating physician employed by H. So, the termination of the contractual relationship lies with the hospital unless Patient B can prove in court that her constitutional rights have been violated. Such escalation would also be the only recourse if Patient B's condition further deteriorated, i.e. if her X virus infection entered the lytic phase such that she became contagious: In an epidemic outbreak scenario that seems possible from the set of facts, infection control law would essentially limit the patients right to 'escape' quarantine and the legal relationship between B and H would be unilaterally prolonged. In the case of an epidemic emergency, public authorities can even decree forced vaccinations or placement in a

quarantine ward, meaning in turn that the hospital, in conjunction with healthcare authorities, would control contractual service scope and duration and, in doing so, possibly no longer take into consideration the intent or even cooperation of the patient. The legal relationship would therefore only terminate when Patient B was deemed to be cured or no longer contagious. Other scenarios in which the hospital may terminate the legal relationship are detailed in Sect. 10.4.3.2.

Should the treatment of the X virus infected patients take priority (such as in a mass casualty event), Patient B's original contract with the External Surgeon S might be suspended or even terminated due to medical necessity. In line with § 17 I (1) KHEntgG, the hospital can immediately cancel ancillary service provisions in order to preserve priority over general healthcare provision (cf. [21], p. 237), and reallocate resources and capacity away from elective surgery patients to those requiring a higher priority triage. A transfer of Patient B to another hospital would be the most likely next step. In such a scenario, the subcontracting mechanisms addressed in Annex 10.4.1.3 come into effect, depending on whether the patient can be readmitted to Hospital H within a day. Should this not become possible, Patient B would be ordinarily discharged and H would by superordinate legal obligation default on its contractual performance to S. As a preemption to compensation claims, the hospital should therefore plan any split hospital admissions contract with a favorable compensation clause, or even opting-out termination or at least delay rights, as the institution is legally obliged to prioritize resource allocation for ordinary treatment procedures anyway.

10.2.2.2 Interim Outcome

This case discussed the transition from an elective procedure, facilitated by a split-hospital admissions contract with an external cosmetic surgeon as attending physician, to a regular urgent procedure which necessitates the switch in treatment responsibility to the hospital. It is important to note the switch in the steerability of treatment outcome, as seen in Fig. 10.5: The rhinoplasty offers more possibilities to control the procedure (f.e. the time of surgery) whereas the X virus vaccination falls under the guidance of social law (such as §12 SGB V). While the medical risks of the vaccination can mostly be relegated to Patient B through her informed consent decision, she risks missing her time slot for the rhinoplasty procedure with her cosmetic surgeon if complications arise with the vaccine, or should the hospital become inundated with too many emergency cases. Still, as the likelihood that such complications arise is low, a normal completion of the cosmetic surgery can be assumed.

10.2.3 Patient C

10.2.3.1 Identification of Decision Options

In this case, the hospital is faced with the challenge of determining the legal capacity of a minor adolescent. Both legal guardians are accessible in this scenario; however, potential

for conflict might arise if Patient C really was exposed to X virus during his stroll through the hospital. Consequently, steps must be taken to prevent the adverse interaction between his ongoing gene therapy and the contagion. As stated in the set of facts, a legal custody battle over C is still ongoing which gives likelihood that both opposing parents would attempt to seek sole custody and might have diverging opinions on the decision as to continue treatment beyond gene therapy.

Q6: Who is entitled to make decisions with regard to Patient C's treatment?
The exact details of how Patient C ended up in the Hospital H are indeterminate; however, it is certain that since he has been in a hospital ward for several days, he can be considered as a normal in-patient who is directly under the care of a treating physician employed by the hospital. As addressed in Sect. 10.4.2.2, any contractual relationship would need to involve the legal guardians of Patient C as he is not of legal age.

The treatment aim throughout the case is to perform the gene therapy to counteract Patient C's neurodegenerative condition. As the treatment has already begun, both parents must had given their informed consent in their function as legal guardians, if a conforming procedure is assumed. With both physicians and the parents wishing to spare the adolescent the ferocious symptoms introduced in the set facts, it is hereby established that intent and objective between proxies and attending physician matches.

Q7: Assuming that Patient C's mother retracts her consent to the blood transfusion treatment on religious grounds, how could a reasonable course of treatment be justified?
With the new event development that Patient C might have contracted X virus, a vaccination becomes necessary. This, however, might lead to the adverse reaction between vaccine and gene therapy causing a certain X virus outbreak in the adolescent. The question facing the attending physician and legal guardians is whether to risk avoiding the vaccination, or to accept certain outbreak through the aforementioned interaction unless the blood exchange is performed. The latter would, however, conflict with the mother's religious beliefs.

Normal procedure would entail the physician having an informed consent conversation with the patient as detailed in the previous case study and in Sect. 10.4.1.2. If the mother persists in rejecting the blood transfusion, the hospital is faced with the dilemma of risking the release of a potential X virus carrier into the public during a potential outbreak scenario, or intentionally risking the neuropathic episode caused by the untreated X virus infection. In addition, the guardians might have the legal option to reject further treatment of their son and force patient discharge despite the treatment being far from complete.

From the set of facts, there is a certain likelihood that the parents will not agree on an appropriate avenue of treatment since both guardians are already engaged in a divorce that could escalate into a custodial battle in which both parents would have to showcase their qualification for childcare and associated ideals. Regardless, if the mother favored

the omission of the blood exchange procedure and the father did not, informed consent would not be established since both guardians need to consent to the course of treatment for their son. In this case, the doctor-patient proxy conversation would be the initial opportunity for mediation. However, if ultimately no consent is reached through it, the Hospital H might then need to unilaterally seek relief from a family court, particularly if Patient C's life is in jeopardy. This in turn might impact the standing of the mother in the original custodial dispute.

However, given the fact that this case is taking place in Germany where minors above the age of 14 can voice their intent, Patient C himself may be consulted in order to align the course of treatment to his preferences. This avenue would however only be possible if the hospital corporate policy allows staff to intervene between disputing parents that are trying to reach a consensus on course of treatment.

10.2.3.2 Interim Outcome

This case served to highlight the importance of managing the relationships between the patient proxies and the attending physician in order to maintain an informed consent decision to continue treatment. The initially unforeseeable occurrence that made Patient C require a vaccination, which in turn would either result in an adverse drug reaction or necessitate a blood transfusion, highlights the difficulty in defining preemptive guidelines in a contract in advance. Likewise, an action needs to be performed, as a termination of the contractual relationship (retraction or denial of informed consent) is not possible in this scenario since the hospital (and health authorities) cannot release the X virus infected patient into the public. Even if a contractual agreement attempting to steer all such scenarios existed, infection control law would supersede any such contract.

10.2.4 Patient D

10.2.4.1 Identification of Decision Options

In this case, the hospital has to unilaterally initiate treatment as Patient D has no legal capacity in her comatose state. Two treatment objectives arise for Hospital H: First, stabilization and treatment of the head injury that resulted from the altercation. Second, steps need to be taken to treat the possible X virus infection that was very likely acquired from Patient D's assailant. This in turn means that Patient D would need to be isolated and retained in the hospital in conformance to infection control law.

From the set of facts, it cannot be determined whether Patient D has received the aforementioned gene therapy. This in turn means that a respective investigation would be necessary. Lastly, since it is likely that Patient D will foreseeably remain in a comatose state, a legal proxy might need to be involved in the discharge management, which, due to the added intricacy of her care level, will involve a more complex interplay with external service providers.

Q8: Which decisions must the attending physician make with regard to Patient D's possible intentions?
There are three main issues the attending physician must consider:

(a) In line with the emergency response chain, the hospital, as the closest and most suitably equipped institution to handle Patient D's condition, would unilaterally initiate treatment under the principles of emergency commitment set forth in Sect. 10.4.1.1. Interestingly, the hospital has, in this case, initiated a procedure that keeps the patient incapacitated, both physically and legally. This means of course, that Patient D is neither able to voice any assent nor any objection towards the treatment procedure, as well as on any contractual relationship with the involved parties. Due to urgent medical necessity, however, the requirement for informed consent can be waived in this scenario. Besides the aforementioned admittance to the hospital (which may be governed through a total hospital admissions contract), the hospital again acts unilaterally within the purported best interest of Patient D, who of course is not able to make a reciprocal declaration of intent.
(b) Hospital H, in conjunction with law enforcement, would need to identify whether Patient D has any relatives or has decreed anyone to act as her legal proxy. Once identified, the legal proxy should be informed about his or her personal liability for treatment decisions as further described in Sect. 10.4.2.2.
(c) Similarly, Hospital H has to decide whether to search pertinent databases or Patient D's belongings for any clues as to whether she has issued a valid patient decree with regards to medical procedures. Similarly, if any qualified proxy is aware of any patient decrees that Patient D might have made, he or she must inform the hospital. Should a legally sufficient declaration of intent have been made, the hospital would first have to validate whether the decree is applicable to the anticipated treatment procedures and, as detailed further in Sect. 10.4.2.1, evaluate whether it was formulated under informed consent-like conditions. If validity is established, enforcement would fall either onto the hospital, or the legal proxy, if so identified.

Q9: Who is obliged to pay for Patient D's treatment?
As from the set of facts, it is apparent that Patient D's assailant is likely to be blamed for the injuries and possible infection with X virus of her victim. Whether or not the attacker had a compelling motive and intent to attack Patient D or whether her infection with X virus lowered her legal culpability would be a matter for the criminal courts. The question of liability for elements of the hospital costs, however, definitely falls within the scope of this case study.

Before the determination of who shall ultimately cover the hospital fees, it should be noted, however, that upon admission, the identity of Patient D and hence, her payor, are unknown. This means that the hospital initially has to advance all expenses for the procedures undertaken within it. In contrast to other industries, hospitals do not really have the option to halt treatment due to uncertain payment. Fortunately, as detailed further

in Sect. 10.4.3.2, social law mechanisms such as the *Krankenhilfe* exist to avoid payor default risk. A conflict between the general management, which would be traditionally inclined to assure the financial wellbeing of the Hospital H, and the clinical domain, which would tend to focus on the treatment of the patient, would therefore also be averted. Of course, it would be prudent of Hospital H to work closely with law enforcement in order to establish the identity of Patient D, or at least identify a legal proxy. As mentioned in more detail in Sect. 10.4.2.4, this allows the hospital to perform medically reasonable tests that aid the investigation, if ordered to do so by the involved police investigators. While Patient D is comatose in this scenario, it is notable that, even if she were in a conscious state, she would have to accept and endure such procedures as long as they don't violate her constitutional rights.

Concerning the accuracy of the billing by Hospital H, it is possible in Germany to select an at-cost remuneration billing scheme instead of the service procedure fee schedule systems addressed in Sect. 10.1.2.1.3. This would allow for a more direct overview of the treatment costs generated by the hospital, even if Patient D is later determined to be covered by statutory health insurance. In the case of Patient D, Hospital H has the ability to handle Patient D's treatment ledger like that of a private patient: The individual billing approach set forth by §13 II SGB V should clearly differentiate the actual incurred costs for later use in liability claims. Still, the cost of all in-house treatment procedures will be the same due to the special nature of the German Hospital Finance Act (§17 I (1) KHG), so no additional compensation can be expected from the hospital for Patient D's treatment regimen. If Patient D is determined to be privately insured, a treatment contract pursuant to §630a BGB would need to be signed with a legal proxy, as treatment costs would then have to be advanced from her own accounts.

With regards to hospital yield management, a prolonged hospital stay can pose a problem if the patient's treatment exceeds the nominal treatment duration guideline for the patient's case. This poses a risk that the hospital might be audited by the medical review board of the insurance, which, as introduced in Sect. 10.4.3.3, can entail further deductions to the hospital's remuneration. It is unlikely that these risks inherent to hospital operations could later be shifted on to Patient D's assailant.

Q10: How can Hospital H proceed if D remains comatose or needs long-term care?
As long as Patient D remains in a comatose state, an ordinary consensual discharge management cannot be performed. Nevertheless, a seamless handover to external post-discharge care has to be organized by the hospital pursuant to §39 I a SGB V since the patient will be in need of subsequent care due to her incapacitated mental state.

Should long-term care, for example, in the case of disability, or extensive physical rehabilitation become necessary, the German Social Code mandates that the hospital orders subsequent treatment steps as defined by §92 I SGB V from external service providers on behalf of the patient for a duration of up to seven days. As further described in Sect. 10.4.4, the determination of required services, qualification of service partners, etc. all lie within the authority of the discharging physician or authorized social service

specialist of the hospital. In addition, the treating physician is able to make a declaration that the patient is unable to work, which in turn has legal impacts on the patient's relationship with her employer (if applicable) and her disability insurance, thereby affecting contractual relationships that go beyond the scope of this case, but nevertheless can have significant social impact on Patient D. The general mechanisms of the hospital's discharge management are to follow the framework contract of discharge management introduced further in Sect. 10.4.4. This means that the CM process steps plan and draft can essentially be ignored as only the names of the partners would need to be input. Steps like implementation, and, to a certain degree, monitoring contract compliance and evaluating the relationship with the external partners would still fall under the responsibility of Hospital H.

Lastly, all possessions that were brought in together with Patient D would also be handed over to the next caretaker. In order to be reimbursed for its operating expenses, the hospital will have to submit the normal renumeration claims to Patient D's payor or to her assailant if so determined by a criminal court.

10.2.4.2 Interim Outcome

If we assume that Patient D does not wake up from her coma and no proxy is identified, we can assume that the hospital acts unilaterally to effect treatment and then discharges her into the long-term care system in accordance with §14 SGB XI. In dealing with the post-discharge care providers as described further in Sect. 10.4.4, Hospital H—through the attending physician and involved social service nurses—will engage in contractual relationships on behalf of the patient. Only here is the CM Approach manifested in its entirety.

10.2.5 Patient E

In this scenario, Patient E is not an active contractual party; instead, he is the intended beneficiary in an arrangement between the prison service and Hospital H. The debate whether the legal relationship falls under civil or social law will, at first sight, become even more convoluted, as public law—in particular, the German Penitentiary Code (StVollzG), §§56–66 StVollzG—will add to the case's complexity: If Patient E were in a statutory health insurance plan prior to his incarceration, coverage by the latter would be suspended. During imprisonment, the state penal system would also be both payor and the responsible party for ordinary treatment that would usually be provided in a prison medical ward. However, due to the complex nature of treatment required for Patient E, a transfer to Hospital H is necessary and also legally required according to §65 II StVollzG. Lastly, German Penitentiary Code itself gives the answer as to whether the treatment of the prisoner falls under contract law:

Explanation: Type and Scope of Medical Services pursuant to §61 StVollzG
For the type of physical examinations and medical prevention services, as well as for the scope of these services and the services for the treatment of diseases, including the provision of patient aid equipment, the respective requirements set forth in the Social Code and the regulations thereof are in effect. (author's own translation)

As the penal system is payor, the contractual aspect of the German Patient Rights Act also is not applicable and thus the service provision of the hospital is not governed contractually. With a public authority as a counterpart, it would therefore also be expected that the transaction would be governed by the (namesake) public law special relationship.

10.2.5.1 Identification of Decision Options

Nevertheless, as Patient E is undergoing treatment as an in-patient of Hospital H, elementary patient rights, as well as constitutional rights still come into play. While Patient E is unlikely to end up in the conflicting scenario of the adverse interaction between an X virus vaccination and the previously mentioned (but in this case inapplicable) gene therapy, the hospital is faced with the dilemma of whether to uphold the arrangement with the prison service such that the inmate can return to prison to serve his sentence after having been treated, or whether to oblige the patient's clear and explicit wish to cease treatment and effect quick patient death, which might be construed as assisted suicide (see Sect. 10.4.3.4). The first decision that the hospital needs to make is whether Patient E's declaration constitutes a valid and enforceable patient decree (see Sect. 10.4.2.1).

In contrast to a prison ward, treatment authority in this scenario lies with a physician from the hospital and not with a prison official. While the justice system still will remain payor, the hospital corporate policy might give a guideline as to the course of action leading to either forced treatment, or to accommodating the patient's intention to refuse treatment and effect assisted suicide. As stated in Sect. 10.4.1.1, there is an ongoing debate as to the function of medical service provision in the correctional facility environment, so this case study will analyze both courses of action so that the reader may develop his or her own opinion on whether assisted suicide should be possible in the case of life imprisonment.

Q11: Has Patient E produced a valid patient decree?
From the set of facts, it can be determined that Patient E suffers from X virus infection at an "advanced stage." At this stage of the disease, it can be assumed that Patient E's nociception is already heightened, meaning that he is already sensing more and more pain, unless he receives counteracting treatment. The determination therefore has to be made whether he is still lucid enough to make a patient decree. In order to give informed

consent or—as a corollary thereof—informed refusal, the patient therefore has to be both capable of understanding relevant information and medical recommendations, as well as able to process them to reach his own opinion through more or less rational reasoning. The cognitive aspect thereof may be tested neurologically by hospital physicians. Here, it should be determined whether the patient is in a state of physiological shock, obtundation, somnolence, delirium, or stupor. The psychological, if not psychiatric dimension would require the consultation of socio-psychiatric services, units of which are commonly found in hospitals. The fact that Patient E stated his intentions "repeatedly" certainly will become relevant in the determination of involved specialists.

Even as an ordinary patient, the patient's reasoning could be challenged, f.e. by asserting that the progression of the infection could have impaired Patient E's reasoning. If so determined, legal guardianship would fall back to the state and its designated representative.

On a constitutional level, the inmate still has his right to human dignity and self-determination (Art. 1, 2 GG, respectively). As described in Sect. 10.4.2.5, jurisprudence furthermore exists in Germany which acknowledges the legal capacity of patients under pain who still elect to forego further treatment and that declaring intent to die does not impair legal capacity. Therefore, the content of Patient E's declaration of intent to at least forego treatment in the hospital appears enforceable.

Decrees of incarcerated prisoners present a unique consideration regarding the aspect of legal capacity: As will be briefly touched upon in Sect. 10.4.1.1, healthcare provision to prisoners represents a special patient-payor relationship, with the prison administrators acting as custodians of the inmate. With regards to prison security, prison officials can make the following arguments that would oppose Patient E's statement of will:

- X virus appears to be a communal disease. Therefore, letting Patient E return to the prison untreated would pose a security and public safety risk as the design layout of a jail (confined rooms, as well as relatively close contact between inmates and correctional staff) propagates the possibility of an outbreak within the facility. In this respect, a determination might even need to be made whether the analogous conditions justifying forced treatment according to German prison law are met.

Explanation: Forced Measures in the Domain of Healthcare pursuant to §101 StVollzG I

Forced medical examinations and treatments as well as forced feeding are only permissible in the case of severe danger to the health of the inmate or to the health of other persons; all such measures must be reasonable for those involved and must be associated with significant danger to the life and health of the inmate. The penal administration is not required to execute such measures, as long as a free declaration of will of the inmate can be assumed. (author's translation)

- Incarceration philosophy could be interpreted in a way that prisoners are to primarily remain captive, inside prison walls, and with their personal rights curtailed (cf. [5]). Enabling inmates to escape penitentiary confines might represent a loophole to their sentence. Should large numbers of prisoners attempt to deceitfully test out this loophole, prison administration, and, to some extent, prison security might be placed in jeopardy by such temptation. Considering Patient E's sentence of life imprisonment, his punishment might even be construed as such that he is to be kept alive behind bars for as long as humanely possible.

As can be seen from the arguments above, both the applicability and nature of Patient E's decree entail arguments both for and against him, likely leaving the courts to decide on the prevalence or either *lex specialis* or *lex superior* in this case. Nevertheless, it should be stated that no differentiation between a normal patient and a prison inmate is made in either the AVB, or in the discharge management framework contract. From the hospital perspective, the hospital could therefore afford the inmate the same rights as any other patient with regards to treatment.

Q12: What are the attending physician's options with regard to Patient's E's patient decree?

Should the hospital elect to best comply with Patient E's request, it would solely treat his symptoms palliatively and prolong the treatment regimen as long as possible. If a hospital doctor is the attending physician, then discharge authority, and hence the decision as to how long Patient E should remain within the hospital, would lie with him or her. It would be prudent and within occupational ethics to periodically check if Patient E had changed his mind with regards to the treatment direction. As described in Sect. 10.4.2.5, the patient may opt out of the course of treatment on the grounds of self-determination as long as it is medically possible.

Should the hospital elect to best comply with the original request of the prison service, it would aim to stabilize Patient E by either administering antiviral agents that would aim to slow or limit the further development of virions in his system, stimulate his immune system, and/or by taking steps to either lower his pain reception or to increase his pain tolerance. Generally, antivirals have varying degree of specificity; therefore, treatment success is not assured, which in turn could result in Patient E's symptoms, and hence the constant pain, being prolonged. Pain management however could be delegated to a prison infirmary and would not require the full services of a hospital.

In order to keep the patient compliant, the hospital physician might be able to invoke therapeutic privilege. As delineated in Sect. 10.4.1.2, physicians can initiate treatment—in this case palliative care measures—on a false pretense towards Patient E based on the reasoning that such deception would prevent him from committing suicide through other means. Of course, it could be argued that an incarcerated individual has less opportunities to commit suicide in the more closely observed environment of the prison than on the outside. However, the torment of the ever-increasing sensation of pain—in particular

for a septuagenarian like patient E—likely corresponds to the preconditions that allow the invoking of therapeutic privilege in Germany, namely the aversion of "most severe damages to the patient," (cf. [26], p. 260).

If palliative therapy shows effect, the patient will be discharged normally on behalf of the treating physician, providing Patient E consents to the discharge management procedure, if he has the liberty to do so. Whereas classical discharge management might involve external service providers, the prison infirmary and pharmacy likely will be the only entities with which the hospital has to coordinate. Treatment method, dosage and means of administration of medications, as well as general suggestions are to be included in the discharge letter.

Q13: Could a contract lead Hospital H out of the dilemma?
In contrast to the previous cases in which the contract's usefulness in the steering of hospital treatment was very limited, a contractual agreement might actually be the best approach to resolve the ethical conflict in Patient E's scenario, or at least to optimize processes in order to avoid further conflicts with the prison services. While social law is to govern the provision of treatment, the reader might recall from Sect. 10.1.2.1.2, that social law does not explicitly preclude the additional manifestation of the agreements between the involved stakeholders in a contract.

Either in anticipation of the conflicts between patient self-determination and incarceration philosophy described in the previous sections, or after gaining experience from the scenario (CM process step evaluate) and thereby seeking to improve processes for the future, the hospital and prison administration can conclude an agreement on the discharge determination process including provisions such as:

- The attending physician, or the hospital's ethics committee (if present) can determine under which circumstances Patient E may be discharged. If a legal dispute between hospital and prison administration arises, both parties will agree to first seek third-party mediation before seeking injunctive relief.
- Instigating the prison doctor as external attending physician through a split hospital admissions contract.
- If the prison doctor is designated as attending physician during the treatment of Patient E within the hospital, he or she will independently make the discharge decision. Of course, even within a split hospital admission contract, the prison doctor will still have to adhere to the same occupational ethical guidelines as his or her counterparts in the hospital.

10.2.5.2 Interim Outcome

The validation of a patient decree and contrasting its intention with that of the prison authority and hospital presents a unique twist on management of relationship. From the hospital's side, considering the bioethical implications of either course of action presented

here, corporate management may issue guiding policies. Furthermore, the designation of the clinical decision-makers and the dispute resolution procedure are best defined in advance in a contract concluded between hospital and prison authority. As such, the CM Approach might facilitate steerable provision of healthcare while balancing the relationship of the sovereign legal parties.

10.3 Learning Outcome

10.3.1 CM Value for the Case Study

The CM Approach mainly focuses on enterprises' management activities which differ considerably from the management of hospital treatment. However, the CM Approach directs attention to the special conditions under which hospitals provide treatment services to their patients and make related decisions.

The fundamental precondition of Contractual Management is the freedom of contracting which obviously does not fully exist for hospital treatment in Germany, even if the hospital is privately owned. The legal framework pertaining to healthcare provision is so tight here that—with the exception of elective procedures—most decisions with regard to the patient are not covered by a contract and therefore cannot be governed by the CM Model's function of the four management fields: risk-, corporate-, knowledge- and management of relationship. However, the CM Approach may be applicable to other aspect of hospital management such as procurement of supplies and services contracts which fall under the principle of freedom of contract. Furthermore, there is strong evidence that it is also feasible for governing elective procedures of patient treatment, which was not the main topic of this case study. However, even outside of its scope of application, the CM Approach can strengthen the understanding of the management of hospital treatment as a different type of management which is mainly governed by a complex structure of stakeholders, a strict regulatory framework covering service quality and service remuneration, as well as bioethical guidelines which limit the freedom of decision-making for the payor, the attending physician, the patient and the hospital manager. In order to provide an effective, dignified, and sustainable healthcare service, the hospital manager, therefore, has to look beyond contract portfolios and case mix summaries to the unique special relationship considerations of public law and social law, as well as the overarching influence of politics, bioethics, and—last but not least—the wishes of the patient and society in general.

The steering function that the CM Approach provides is therefore relegated to the relatively closed domain of healthcare stakeholder interest groups whose mutual exchange fortunately is facilitated and enforced by legal mandate.

10.3.2 Case Study Value for the Reader

The reader might contemplate on the following learning outcomes of this case study:

- The patient-hospital-payor relationship is extremely complex and is flanked by highly detailed guidelines and stipulations through the legal framework, as well as the ethical doctrines that encompass the medical profession.
- In a convolute of legal philosophies and an at times uncertain constellation between *ius dispositivum* and *ius cogens*, both patient and healthcare professionals can face difficulty in understanding the legal framework and in anticipating eventualities arising from the legal relationship between them. In conjunction with the resource constraints encountered in many hospitals, the question arises whether, with an increasing regulatory density, compliant implementation might itself become increasingly risky. The reader may then contemplate whether and where a saturation point might be reached, at which legal risk in the hospital domain unnecessarily increases the cost of healthcare provision.
- Contractual manifestations governing the patient-hospital relationship do exist, but can be easily superseded, if not circumvented, by means that are not commonly encountered in classical transaction contracts.
- It is noteworthy that contract management and contract enforcement commonly does not lie with the general manager of the hospital, but rests in part with the treating physician, nurses, and administrative staff who are in contact with the payor and regulatory authorities.
- The conduct and compensation of healthcare professionals in Germany is governed by occupational law and regulations, as well framework contracts at the association level. With regards to this regulatory framework, as well as the general concept of medical prerogative, the lay patient hardly has any steering capacity through a contract.

10.4 Annex: Compendium on the Foundation and Implementation of Hospital Treatment Contracts

This compendium serves to provide deeper insights into the distinctive aspects facing the contracts that aim to envelop hospital treatment. While the difficulties in attempting to steer the entirety of the hospital stay through a single contract as envisaged by the CM Approach have already been portrayed in Sect. 10.1.1, this annex will analyze to what extent the CM Approach is applicable to individual phases of the service provision in a hospital. For this, the hospital stay is corresponded to the main stages of contract management theory: Contract Formation, corresponding to the admission to the hospital during or preceding treatment (Sect. 10.4.1), Contract Performance, analogous to the provision of treatment itself (Sect. 10.4.2), and Contract Termination, which represents the end of treatment leading to discharge of the patient (Sects. 10.4.3 and 10.4.4).

10.4.1 Special Conditions on Contract Formation

10.4.1.1 Unilateral Treatment: Emergency and Involuntary Commitment

In classical contracting, **contract formation** is established by mutual assent (the "meeting of the minds" connecting the intent to provide a service by the offeror with the acceptance of said offer by the offeree, thereby signifying the agreement of both parties to comply with the (binding) terms of the agreement (cf. §146 BGB)), often supplanted by a consideration clause. However, in the domain of urgent and emergency care (which of course represents the bread and butter business portfolio of most hospitals), the opportunity that the patient can make his or her own selection between the services of different hospital offerors seldomly arises. More 'competition' exists, however, if the patient intends to undergo an elective procedure or is able to proactively seek hospital treatment abroad. In consequence, the need for Contractual Management manifests essentially only in the latter scenarios.

In **cases of patient incapacitation**, the physicians (and hence the 'contracting party,' the hospital operator), are permitted—if not already legally obligated—to initiate treatment unilaterally, meaning an offer neither needs to be made, nor be accepted. In this very common scenario, the hospital is acting as legal proxy and has to pursue the assumed intention of the patient (cf. §677 BGB). Resulting necessary expenditures can then be charged to the patient's payor (cf. §683 BGB); only the provision of elective services (such as defined by §16 (2) BPflV and §17 II KHEntG) require written agreement.

Healthcare provision by the hospital might also be **initiated by law enforcement**, f.e. if medical investigations are necessary in criminal investigations (cf. §§81a, c StPO), or if psychiatric intervention is deemed necessary **by court order** (cf. §1096a BGB). Obviously, the autonomy of the patient to engage in a contractual relationship is effectively nullified in such involuntary commitment scenarios such that the patient is legally obliged to undergo treatment. Consequentially, the 'service delivery' of the hospital is once again not governed by contract law (cf. [27]), and continues unless a legal proxy or a court intervenes. This in turn limits the applicability of the CM Approach once again, as a reiteration of the 'contract' or, more precisely, the transaction is not governed by mutually agreed upon stipulations between hospital and the criminally investigated or psychiatric patient. Similarly, freedom of contract formation between hospital and the public authority which holds custody over affected individuals is likewise curtailed, as social law usually stipulates patient referral to the closest suitable facility. This in turn means that CM aspects, such as a transaction-specific management of relationship, play little relevance for the sustenance of involuntary commitments.

A special variation of a potentially involuntary commitment exists if the prison system elects a hospital to continue treatment of a prisoner: In countries like Germany, statutory health insurance rests for the duration of incarceration and medical treatment of inmates is provided by a prison's own medical ward. Most German states have their own prison hospital system; only in severe cases are inmates transferred to local hospitals.

Therefore, the authority to initiate treatment lies with the state while it also acts as payor for medical services (cf. [31]). Touching upon a legal philosophy debate that would quickly exceed the scope of this book[1], this can lead to a conflict of interest between the budgetary constraints and a premise of sustaining the serving of a sentence on the one side, and the provision of humane, constitutionally compliant medical care of prisoners that should be governed by due process, on the other. In *Wenner v. Germany* [53], the European Court of Human Rights maintained that inmates are to receive medical care equivalent to the population average. Prison authorities even have to obtain independent expert opinion when deciding on treatment substitutions (cf. [20]). Here, the prison and hospital might take up opposing views, respectively. German prison law also permits forced medical treatment (and, likewise, forced feeding) only in life-endangering conditions, scenarios in which the health of the inmate or others are jeopardized; furthermore, unless in a first-aid scenario, such measures must be performed by the order and under the supervision of a physician (cf. §101 III StVollzG). Such scenarios likewise exceed the applicability of the CM Approach.

10.4.1.2 Informed Patient Consent and Therapeutic Privilege

As early established in various legal systems, **performing a medical procedure against the will of a patient constitutes bodily injury** which may result in criminal prosecution[2,3]. Therefore, any medical treatment requires the consent of the patient, a procedure which is valid only if specific requirements are met.

Explanation: Doctrine of Informed Consent

The doctrine of informed consent was **first defined in the 1950s** in the United States (cf. [12]), p. 324), and consists of two major elements through which the patient is to gain a sufficient decision-making basis for the subsequent treatment steps. First, the patient is to be informed on his or her condition and the current diagnosis. Second, the patient is to receive an explanation of the risks and benefits of a treatment in sufficient detail ([38, 49]) regarding both short- and long-term[4], the risks of adverse interaction between the treatment and other drugs the patient might be taking, as well as those of alternative courses of treatment, including non-treatment. An opportunity should be given for the patient to reflect upon the

[1]For further reading (see [34] [35]).

[2]For Germany, cf. [49].

[3]For the United States, cf. *Schloendorff v. Society of New York Hospital*, in which the court held that "[…] a surgeon who performs an operation without his patient's consent commits an assault for which he is liable in damages" [50].

[4][36]: Here, a cancer patient undergoing radiation therapy was not informed about the long-term side effects of treatment, as the physicians claimed that providing such information would cause undue psychological distress to her.

decision and, if possible, time to seek third party opinion. In conjunction, information on any therapeutic steps subsequent to the treatment in the hospital should be given (cf. [26], pp. 260–262).

In the United States, a physician's obligation to acquire informed consent is delineated in the hallmark case of *Canterbury v. Spence*[5]. Here, the court held that the plaintiff patient has the right to receive a reasonable description of the treatment risks from the physician, even when the patient does not explicitly ask for it (cf. [43]).

In Germany, contract law also establishes additional information disclosure duties:

- Notification upon inquiry for the aversion of medical dangers about circumstances which may lead to the assumption of a medical treatment error[6].
- Notification in writing (cf. §126 BGB) about the estimated financial consequences of treatment, if and only if costs are not covered by insurance (§630c III BGB and §13 II SGB V), or when reasonable doubts towards the reimbursement exist [41]. The physician, however, is neither obligated to perform financial consulting, nor to investigate actual coverage (cf. [26], pp. 261–262). In this regard, Rehborn argues that an unforeseen worsening of a patient's medical condition such as development of sepsis can very quickly escalate costs which therefore makes a cost estimate of medical treatment not accurately calculatable (ibid., p. 262).

Acquisition of informed consent may be skipped if emergency treatment cannot be postponed or if the patient explicitly relinquishes his or her right of informed consent (cf. §630e III BGB).

It is particularly noteworthy, that several **rulings from the German Federal Court of Justice** ([37, 39]) mandate that the provision of information to the patient should occur in a confiding conversation between doctor and the latter. A ruling in 1985 explicitly found that this conversation cannot be substituted by the sole signing of consent forms (cf. [2], pp. 40–41, [26], p. 267, [40]). One can therefore deduce that any signed consent form can only function as an annex to a treatment contract, but not as an independent contractual instrument by itself.

Patient consent essentially was integrated into the reform of the German Civil Code through the Improvement of Patient Rights act of 2013 (cf. [26], pp. 263–266), as

[5]In this case, a patient was nearly paralyzed in the course of treatment against back pain but was not informed about this risk by the defendant physician prior to the laminectomy procedure. For more details, please see http://www.lawandbioethics.com/demo/Main/LegalResources/C5/Canterbury.htm.

[6]The concept of physician self-incrimination is detailed in §630c II (2) BGB.

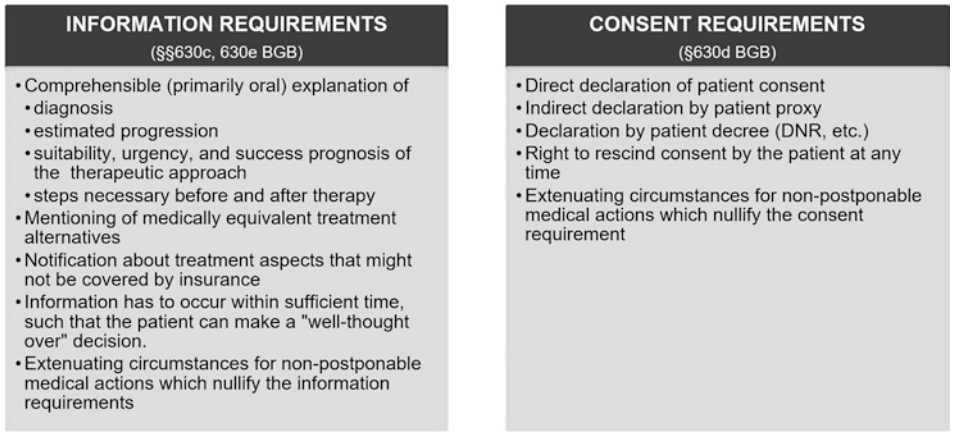

Fig. 10.7 Informed consent legislation in the German civil code

depicted in Fig. 10.7. The mandatory legal connection between information and consent elements is formalized in §630d II BGB.

In another unique divergence from classical contract law, the patient informed consent requirement can however be circumvented: Should the disclosure of treatment information by the physician pose the risk of the most severe consequences (f.e. there is a risk of patient suicide), the physician may withhold or modify information on the diagnosis or not disclose details on the course of treatment (cf. [34]). This so-called **concept of therapeutic privilege** has different degrees of manifestation in various countries and cultures; in Germany for instance case precedent limits the concept's application only to exceptions when the "most severe endangerment of the patient," (cf. [7], [41]), or the when the aforementioned patient suicide could be averted (cf. [26], p. 260). Nevertheless, if transposed to classical contract law, enticing a business partner to enter an agreement based on false or incomplete pretenses (as would be the case in the just-mentioned scenarios) would equate to deception (§108 StGB), which for normal transactions would invalidate the contract and may even have penal repercussions[7]. In order to maintain verifiability and a documentable trace of the invoking of therapeutic privilege, any such act must be recorded by the physician in the (electronic) patient record (cf. [7]), which would touch upon the premises of knowledge management.

Transposing the processes of acquiring informed consent from the patient to the **CM Approach shows certain parallels** in that there is a phase for preparation (planning and

[7]According to §263 StGB, "[…]maintaining an error by pretending false facts or by distorting or suppressing true facts shall be liable to imprisonment not exceeding five years or a fine." Even the attempt is punishable.

drafting) on both sides, especially on behalf of the physician who has to link his or her offer to the diagnosis, as well as to formulate a general cost estimate which in turn might require taking the patient's insurance coverage status into consideration. In conjunction with the patient-physician conversation, and at times supplanted by an optional patient consent form (as later explained in Sect. 10.4.1.4), this can be considered an amalgamation of the debating and proposal phase. However, due to the pricing control mechanisms in the hospital domain in Germany and the concept of medical prerogative, very limited bargaining is possible from the patient's side[8], even in an elective procedure. However, as already addressed previously, acquiring informed consent may be skipped in cases of medical emergency; therefore, all aspects pertaining to negotiation elements in the CM Approach can be superseded.

10.4.1.3 Hospital Selection and Hospital Transfer

As stipulated in the German Social Code, patients are to be delivered to the closest hospital within its catchment area as defined by the state's hospital provision contract which essentially regulates the **zoning of hospital business** (cf. §73 IV SGB V). The zoning area and operating license is fixed in a contract between the state, the state association of German health insurances, and the institution itself, cf. §108 et seq. SGB V. The goal behind such zoning is to assure sustainable hospital resource utilization and its business case within its catchment area. This in turn has the consequence that patients with statutory health insurance plans are compelled to seek a hospital close to their residence and that doctors and emergency vehicles always have to transfer patients to the closest suitable hospital. An unrestricted selection of the hospital, or hospital tourism for non-privately insured patients in general is therefore rather limited in Germany, but legally still possible[9].

Another special scenario arises if the hospital has to **transfer patients to another institution**, as is common when the hospital's resources are limited (f.e. due to a catastrophic event requiring triage) and treatment cannot be continued. In such a situation, treatment and hence the primary contractual relationship is stopped, and the patient is discharged and transferred to the next hospital, normally within 24 h. Secondary contractual obligations, like management of personal belongings, or documentation and health record requirements of course are sustained. Interestingly, although the discharging hospital advances the costs for the transfer to the next institution, coverage falls either to the hospital's payor or to the patient him or herself, although the latter commonly is neither

[8]Examples of negotiable treatment details could of course be the approximate date of when the procedure is to be initiated, optional ancillary hospital services like accommodation or translation services, or—if medically permissible—the question between local anesthesia or full sedation.

[9]§13 IV SGB V allows publicly insured patients to seek medical treatment at an accredited institution within the European Economic Area and Switzerland, but limits monetary reimbursement only to the equivalent that would be payable in Germany.

involved in the selection of the transport service provider, nor the negotiation for the conditions of transfer. Alternatively, the hospital may transfer the patient temporarily such that he or she is returned on the same day, and the original contractual treatment relationship is sustained. Here, transport costs remain the responsibility of the sending hospital (cf. [15], pp. 104–106).

10.4.1.4 Patient Consent Forms

In order to reduce workload on physicians and nursing staff resulting from acquiring informed consent (as detailed in Sect. 10.4.1.2) and to facilitate the conveyance of this information through standardized means, **patient consent forms** are usually handed out to patients at the beginning of treatment. As these forms are specific to a particular pathological condition, a management system needs to be established in order to retain an overview as to which patient received which form(s) and whether, or who signed the respective document. Here, similarities to knowledge management as addressed by the CM Approach can be found. Such management systems have become highly digitalized and may now incorporate the usage of smart devices. Also, advanced consent management systems, such as E-ConsentPro from Thieme Compliance[10], form an amalgamation between patient self-reporting and the latest developments in patient education, thereby providing the means for the individual patient (or his or her guardian) to be (re-)integrated into the decision-making process.

In a first part of such an interactive consent form system, the patient or guardian thereof receives treatment-related information (such as description of treatment plan options, risks and alternatives) upon which he or she can base an informed consent decision. In a second part, the act of consent is then further underscored with the patient interactively filling out a questionnaire that culminates in his or her consent signature. The contents of the consent form could therefore correspond to an offer by the hospital and conscious acceptance on behalf of the patient. Matching offer and acceptance of course are one of the fundamental pillars of contract law.

While the intent of the German Civil Code sections on informed consent stress, as previously addressed, the importance of giving non-bureaucratic and hence oral information to the patient, the patient consent form—if used—can be considered a comparable instrument that would **correspond to a transaction-steering contract** that has so far been addressed through the CM Approach. As the usage, contents, and means of conveyance (for example through digital media) continues to develop, the evolving consent form, as well as its management can therefore also be anchored to the CM Model's knowledge management elements.

[10]For more information, see https://thieme-compliance.de/en/access-to-e-consentpro-software/.

10.4.2 Special Conditions of Contract Performance

10.4.2.1 Patient Decrees

Should the patient be incapacitated to make informed consent decisions or choices with regards to further treatment steps, the hospital has to either consult a legal proxy/caretaker, or, if these cannot be found, determine whether the patient has stipulated a particular medical course of action in a patient decree. In urgent cases, the search for such legal representation may however be foregone, and physicians are to act within the presumed will of the patient (cf. [29], p. 63).

Patient Decrees

Patient decrees typically explain limitations to treatment steps that the patient has declared in writing. The most common example is the so-called Do-Not-Resuscitate order (DNR) which declares that if the patient's malady has entered an irreversible and terminal progression (cf. [23]), life-sustaining measures (such as forced feeding, or cardiopulmonary resuscitation) are not to be performed. Other common patient decrees address the prohibition for certain medical analytical procedures.

In Germany, formal and content-related requirements to the creation and implementation of a patient decrees are defined by civic law (§§1901a,b BGB). Informed consent for the establishment of a valid treatment-specific decree requires the contribution of a medical professional. Evaluation on the applicability of an individual decree lies within the responsibility of the hospital.

Consequently, patient decrees can have a fundamental impact on the formation of the treatment contract, or, as later addressed in Sect. 10.4.3.4, contract termination. This in turn means that the hospital has to maintain a functioning **knowledge and compliance management** over patient decrees comparable to what is envisaged in the CM Approach: The various hospital staff members that are responsible for the patient must be (made) aware of and be able to interpret the intended will of the patient, as well as enforce it if necessary. Should no definite patient decree exist, the hospital might even have to identify and contact "close relatives and other persons enjoying the confidence of the person under custodianship" (§1901b II (2)) in order to investigate the presumed will of the patient (cf. [29], p. 65).

However, it is often very difficult for the hospital to determine whether a decree actually exists and is still in force for a particular patient. While several governmental and private patient decree repository projects exist, hospitals in Germany are not legally obligated to consult these (cf. ibid., p. 67). Furthermore, it should be noted that, in Germany, a patient decree is only valid if either the patient or a legal proxy thereof has received sufficient information to give informed consent (cf. [26], p. 263).

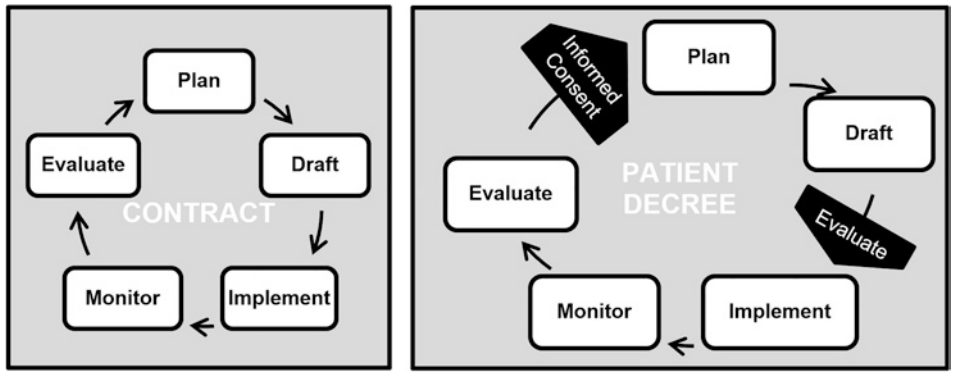

Fig. 10.8 CM cycle (left) and adaptation to the patient decree (right)

Since the patient decree is to be adhered to with an almost contractual nature, it might be advisable for the **hospital staff to involve itself in an advisory position** in the declaration of the patient decree, should the opportunity arise. This way, affected employees of the clinical domain are immediately involved in the CM process steps 'plan' and 'draft' as described in the CM Model and directly gain awareness of issues that will later be substantial in the CM process steps implement and monitor phases, as shown in Fig. 10.8.

Consequently, a lengthy detour of knowledge provision and management from non-clinical business units (such as a legal department) into the clinical domain can also be minimized. To consolidate sources of directive information, it would be prudent to place any patient decree as annex of any treatment contract, if possible. With increasing experience in the drafting and implementing of patient decrees, affected clinical employees would also gain practical insights on how to meaningfully contribute to the process improvement in the informed consent provision and how to better accompany affected patients, relatives, or proxies.

10.4.2.2 Legal Proxies of the Patient and Their Liability Towards the Hospital

In contrast to a patient decree, a patient may also expressly designate a **legal representative** to make treatment-related decisions (§§167–179 BGB). For minors or spouses, close relatives can similarly be considered legal proxies. Alternatively, the state may assign a legal representative as well, f.e. a social worker. In all cases, the proxy enters a contractual agreement with the hospital with the patient as intended beneficiary and ends up with the obligations of a contractual partner (cf. [29], p. 36). Liability of the proxy towards costs accrued by the hospital arises only if there is a deficiency in the conferment of authority, or extent thereof, or should the patient be able to retract the

conferment. To avoid such complications, the hospital has to inform the proxy about the extent of his or her liability (cf. ibid. p. 37), in particular, by providing of an approximate cost prognosis if an exact cost estimate is not yet possible. According to the German Civil Code (§179 (3) BGB, financial liability is however limited if the proxy is not aware of his or her status, or if there are deficiencies in the conferment of authority. Such a scenario entails the risk of not being able to collect all its charges to the hospital.

In Germany, more detailed proxy obligations exist for **family members**. In particular, spouses are entitled to engage in business transactions that "appropriately provide the necessities of life of the family" to the benefit of their partner (§1357 BGB). As ruled by the German Federal Court of Justice [40], medical treatment recognizably falls within the purview of this statute. Consequently, providing the marital status is undisputed, the spouse can *ex officio* become contractual partner to the hospital and—especially in cases of incapacitation of the spouse—has to be involved in decisions regarding the continuation of treatment. Also, the spouse will become liable as joint debtor for elective treatment costs that are reasonable for the necessities of life, but which exceed coverage by the patient's payor (cf. §8 V (1) BPflV). From a liquidity perspective, the hospital may also claim advance payments upon the eighth day of treatment (cf. §8 VII (1) KHEntG). In parallel, the scope of spouse liability extends to children arising from such marriage, cf. §1360 & §1360a (1) BGB. In this regard, the hospital might have to analyze the outward appearance of the financial conjugal standing in order to anticipate the cost span of additional services. Such processes would mirror elements that can be found in the CM pre-award phase.

Should the patient be a **minor**, parents or legal custodians will act as proxies. While parents should jointly make decisions for their child patient, the legal situation becomes more complicated if parents are divorced or are engaged in a legal custody battle: in a non-confrontational scenario, one parent confers authority to the other and consents that the latter makes the treatment decisions. Alternatively, both parents could become contractual partners (beyond proxy status) with the child as intended beneficiary. Lastly, should f.e. no agreement be reached between the opposing parents, the child itself could become contractual partner, with either parents—due to child support obligations (as defined by §1610 BGB)—still liable for any hospital costs not covered by insurance (cf. [29], pp. 38–39). In case of dissent amongst the parents regarding the direction of treatment, the hospital also has the option to refer the case to a family court. As the court would have to be involved in the case of dissenting views anyway (cf. [18]), this would in particular be the case if the refusal of treatment by one guardian would amount to parental neglect (cf. [29]).

While a child below the age of seven is inherently considered legally incapable in Germany, **limited legal capability** for contracting can be presumed for an adolescent (§106 BGB), depending on the individual mental development and cognitive skills of the child. This means that qualified declarations of intent can be considered in the decision-making process for the treatment of the adolescent.

10.4.2.3 Involvement of Third Parties and Hospital Liability Thereover

Over the course of treatment, many third parties can become involved in the handling of the patient that are not directly affiliated with the hospital but are still involved in the contractual service provision.

Contract Knowledge: Split hospital admissions contract & Total Hospital Admission Contract

One of the most intricate legal relationships is when the hospital solely acts as a facility and resource provider to an external attending physician who (by definition of §121 II SGB V, §18 I KHEntG, §22 I BPflV, and§39 of the federal framework contract for physicians (BMV-Ä)) conducts medical procedures for the patient he or she has treatment authority over and over whom the hospital has no medical prerogative. In this scenario, the hospital may be considered like a dry-lease where just its facility and provisions of services like sterile goods processing and accommodation are hired.

Care must be taken in deciding who will be responsible for assuring compliance to local regulations during treatment and who determines whether external contractors possess the necessary licenses for their jobs. In Germany, this essential outsourcing of the treatment authority to a physician who is not employed by the hospital is addressed in a so-called **split hospital admissions contract**[11]. Herein, the external doctor's right to issue directives to hospital support staff (f.e. to surgical assistants in the operating room) and the coordination between hospital and external physician towards the provision of care for the latter's patient is established. Consequently, all liability and cost obligations from the patient's and payor's perspective are directed towards this external 'contractor' for his or her services and not the hospital (cf. [29], p. 81). A similar approach is used if the patient elects to engage the services of an external midwife. In the most extreme version of the split hospital admissions contract, the patient brings along an entire medical team with him or her.

The split hospital admissions contract can be distinguished from the so-called **total hospital admissions contract**[12], in which the hospital obliges to provide all required medical services to the patient. This contract does not have formal requirements but may be supplanted by further agreements for additional physician services, such as having the department head of a unit act as treating physician.

[11]Original term: *Gespaltener Krankenhausaufnahmevertrag.* Within the AVB, a contract draft concerning patients treated by an attending physician is provided (cf. [9], pp. 10–16).

[12]Original term: *Totaler Krankenhausaufnahmevertrag.*

Regardless of who conducts the medical procedure, however, the hospital has to forward patient data, and, consequently, personalized data as addressed by the European General Data Protection Regulation (GPDR) to various entities: Most obviously, these include invoices to the patient's payor (Art. 6 b, f GDPR) and reporting to healthcare authorities (Art. 6 d, e GDPR). Other external entities include the patient's general practitioner or other healthcare facilities which will continue the patient's treatment, suppliers, religious representatives (f.e. for conducting of last rites), and coroners. **Data forwarding consent is integrated together with the general patient discharge forms that the patient may sign**, such as Annexes 6, 8, and 9 of the AVB model contract[13].

10.4.2.4 Unilateral Treatment Prolongation by the Hospital

As mentioned in greater detail later in Sect. 10.4.3.2, authority to discharge the patient from the hospital lies with the treating doctor. In turn, this authority implicitly holds the unique effect that the hospital has the rightful ability to unilaterally prolong the (contractual) relationship, -a fairly uncommon scenario in most 'normal' aspects of contract management. With regards to the CM Approach, this means that the hospital may therefore control when the post-award phase is initiated.

Justified reasons to keep—and, if necessary, even restrain—the patient in the hospital include protection of the patient post-surgery, and when the patient has contracted an infectious disease or would otherwise be an endangerment to public safety. In line with respective infection control laws and regulations, the patient has to accept any procedures that are conducive to an investigation to type, cause, and degree of infectiousness of the contracted disease. Commonly mandated investigative procedures include physical examination, diagnostic tests of bodily fluids and of tissue swipes of skin or mucosal membranes, as well as medical imaging. Personal objections -for example on the grounds of religious convictions—are superseded in such situations. According to §25 (3) IfSG, a patient in Germany has to give consent only to invasive procedures or procedures that require anesthesia.

A similar curtailing of the patient's (contractual) freedoms occurs when the latter is forcibly admitted to the hospital by law enforcement or the justice system: If the patient is suspected of a crime, the hospital may conduct tests that are conducive to the criminal investigation or are necessary to determine the identity of the suspect as long as they are medically reasonable and do not endanger the patient. Guidance on the limits to medical examination for court investigations may be found in the American case of *Union Pacific Railway Co. v. Botsford,* where the court prohibited exploratory surgery in such a scenario [52].

[13]cf. [22], pp. 195–199. The patient information disclosure notification is mandated according to §39 Ia (9) SGB V.

10.4.2.5 Refusal of Individual Treatment Procedures by the Patient

German Social Code allows the **patient to reject treatment** that is extraordinarily painful or an endangerment to his or her life (§65 II SGB V). In many countries, the patient's right to refuse medical treatment is similarly anchored constitutionally or by case law[14] through the personal right to self-determination, as well as the concepts of bodily integrity, and human dignity[15]. Should a procedure nevertheless still be performed despite the express forbidding by the patient, this act would constitute bodily injury. Court rulings exist (cf. [47]; [29], p. 71–73). in which a patient is enabled to prevent a specific procedure to be taken during treatment. Nevertheless, as long as the overall consent or declaration of will towards a general treatment objective has been given, actual control over the medical professional's work steps by the patient is next to unheard of since the treating physician has medical prerogative and is free[16] to design his or her course of treatment, as long as it conforms with de *lege artis*. As a consequence, physicians are not to receive any occupational directive from non-physicians (cf. [10]). Patients may declare preferences to certain treatment procedures, but the German Physician's Association advises that physicians do not have to oblige such wishes if no specific indication for the desired treatment exists or if the legal framework gives constraints (cf. [18], p. 882).

Nevertheless, special conditions come into effect for **minor patients**: Withholding of emergency or even urgent medical care may result in intervention of the family court system. Also, as declarations of intent by adolescents (ages 14 and above) is recognized in Germany, parental refusal against a medical procedure may be overstepped (cf. [29], p. 72). In either case however, it becomes the hospital's obligation to initiate court intervention against the legal guardians, thereby jeopardizing the management of relationship element of the CMM.

Lastly, a very special legal condition arises in a scenario in which a **patient is under investigation** by criminal authorities but refuses treatment. This places the hospital in conflict with upholding patient rights and law enforcement: Indeed, there has been a case in the United States (cf. [19]), in which a hospital nurse sought to prevent a law enforcement officer from taking blood from an unconscious patient without a warrant, which initially even lead to the (false) arrest of the nurse on the grounds of obstruction of justice. This legal dispute ultimately led to a corporate policy not to leave patients and law enforcement officers together unattended (cf. [1]). As such, scenarios in which hospital staff act as protectors of patient rights place the institution at an interesting influential, perhaps even regulatory, position between the quasi-contractual relationship to its patient and the public law special relationship to law enforcement.

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[14]In the United States, the Supreme Court case of *Cruzan v. Director, Missouri Department of Health* established the right to refuse treatment in 1990 [44].

[15]cf. Article 3—Right to integrity of the person in the EU Charter of Fundamental Rights.

[16]The German term *ärtzliche Weisungsfreiheit*, or 'physician's freedom from directive' is perhaps a more fitting description for the occupational freedom from constraints. The concept is also mirrored in §1 II of the German Federal Medical Practitioner's Act (*Bundesärzteordnung (BÄO)*).

10.4.3 Special Conditions on Contract Termination

The freedom to terminate a contract is usually governed by civil law (such as Germany's §626 BGB et seq.) and contractual statutes. While, in general, these principles still apply to the hospital-patient relationship, additional facets need to be considered.

10.4.3.1 Cessation of Treatment Initiated by the Patient

In general, patient and physician are to cooperatively work towards a successful treatment outcome as stipulated in the German Civil Code (§630c I BGB). From the patient's perspective, his or her treatment may be terminated by either **request of the patient** as long as he or she is still deemed to be mentally capable of making this decision, or—as detailed analogously in the previous section—no medical or regulatory reasons preclude a discharge by the hospital. In other countries, similar interpretations of the right to refuse treatment can be found, as stated in the ruling of *HCA, Inc. v. Miller*, "[…] the logical corollary of a right of consent is a right not to consent, i.e., to refuse medical treatment" [46].

In the **German AVB**, there is a comparable termination clause for discharge at the patient's request against the explicit advice of the physician; the AVB also states that the hospital shall not be held liable in case of unauthorized patient egress (§2 III (3b) AVB, cf. [9], p. 5). In case of mental incapacitation, the processes delineated in Sect. 10.4.2.2 likewise come into effect.

A unique aspect of contract termination is the abortion of a fetus; depending on respective family law of the country in consideration, both parents must give consent to such a procedure. The legal ramifications to be considered if there is dissent amongst the involved parties exceeds the scope of this text; regardless, the hospital must be certain that all parties, as well as social service or judicial authorities, are kept appraised of the decision-making factors pertaining to the procedure. From a contractual standpoint, the abortion decision would equate to the cessation of care provision and switching of the treatment outcome to the removal of the fetus, similar to a change order.

With regards to the contractual performance of the patient, it is notable that, unless he or she is self-covered, the patient usually has no influence on the payment of the hospital by his or her payor: both on the question as to whether reimbursement is to be made at all, and as to how much of the claims will be paid for. Therefore, the **patient has limited bargaining power** over the hospital in the case that he or she is unsatisfied with the service provided[17]. Consequently, steering possibilities of either contractual partner within the purview of the CM Approach towards contract renewal are rather limited.

[17]Essentially, the patient may officially file protest at the association-level ombudsperson, as depicted in Fig. 10.4.

10.4.3.2 Cessation of Treatment Initiated by the Hospital

On the side of the hospital, discharge authority primarily lies with the treating doctor. Once the treatment is deemed complete, only the remuneration of the hospital remains as a compensatory performance obligation by the patient, or his or her payor. Prior to a regular, ordinary discharge, there are however three scenarios that need specific consideration:

(a) Patient Expulsion due to non-coverage/non-payment: While a denial for subsequent services on grounds of non-payment is common in other industries, expelling a patient from a hospital during treatment due to the former falling into financial arrears, entails the risk to the hospital or treating doctor to be exposed to medical malpractice liability or to be in violation of social law. In countries like Germany, the *Krankenhilfe* backup compensatory system, legitimized by social law (§48 SGB XII) and funded by municipal social services, exists to alleviate the financial losses incurred by the hospital if an insurer cannot be determined. However, internationally speaking, there is no comparable guarantee in every country.
The aforementioned system however does not cover elective services, such as optional single-room accommodation, which the hospital provides within its own freedom to conduct business (cf. [21], pp. 237–239).

(b) Triage Prioritization: However, even if contractually agreed upon, the hospital has the option to suspend such optional service agreements in case it has to prioritize resources to maintain its legally-defined primary function, such as, for instance, in case of resource scarcity or mass casualty events. This ability to unilaterally cancel such contractual agreements without prior notice once more shows a unique inversion of the CM Approach as corporate management would prioritize and, if necessary, be legally forced to sacrifice contractually agreed upon efforts of transaction management.

(c) Renitent Patient: The most complex scenario arises if the **patient is uncooperative** with regard to the treatment processes but doesn't agree to transfer to a different physician or institution. If the offered treatment steps are without alternative but a medical necessity and if there are no indications that the patient has an impaired legal capacity, the hospital and its staff are faced with a dilemma between the patient's right for self-determination, on the one hand, and the duty-to-rescue and duty to avert subsequent damages towards the patient, on the other. In such scenarios, the physician has the means to use an extended set of methods to persuade the patient, including a rescission of the physicians' medical confidentiality to contact relatives to argue with the patient (cf. [29], p. 71). Should, however, all measures be futile and the patient not yield, an effective means to terminate the contractual relationship is to report the uncooperative behavior to the patient's payor: Usually, insurance companies are not inclined to waste money on wasted hospital stays (as detailed in the subsequent Sect. 10.4.3.2).

Contract termination is, furthermore, much more easily justified if the **patient actively endangers** hospital staff or other patients (f.e. in cases of assault), or if he or she breaks house rules. It is interesting to note that in all variations of the AVB, a termination clause for this scenario is not included. Of course, criminal liability quickly comes into play here. Lastly, it should be noted that if there exists a risk to the patient's life, the hospital regardless is not allowed to discharge the patient solely on grounds of his or her renitence.

Of course, should the hospital be required to transfer the patient to another institution[18], the legal relationship regarding the treatment ends just like a regular discharge with all respective responsibilities entailed.

10.4.3.3 Cessation of Treatment Initiated by Payor

A more immediately impelling motive to stop services to the patient however is when the patient's **insurance refuses coverage** of the patient's treatment. In Germany, statutory health insurance companies have a unified medical review board (*Medizinischer Dienst der Krankenkassen (MDK)*) which may on the basis of either medical records from the hospital or independent medical examination, evaluate the necessity of medical procedures used on a patient (§275 II SGB V), or deem treatment as complete and even declare a patient as fit to work again (§275 I (3) SGB V). In turn, the insurer may also mandate a preventative treatment that is deemed to either "improve the state of health or prevent a worsening thereof" (§63 SGB V). Therefore, a superordinate authority on the side of the payor exists on the question of treatment continuation. However, it should be noted that it is common that an audit by the medical review board of the insurances can in turn result in medical procedures by the hospital being deemed as unnecessary, with the consequence that the hospital has to reimburse payments, despite having already performed these services at its own cost (cf. [8]). Lastly, social court proceedings may be initiated to bring injunctive relief on coverage questions.

A denial of coverage scenario is commonly the case in **experimental or highly expensive courses of treatment** such as cancer therapy once the payor's coverage is (about to be) exceeded. The hospital itself may then find itself in the position to terminate the contractual relationship regarding the treatment in opposition of its own motives and those towards the intended beneficiary.

10.4.3.4 Patient Death/DNR/Assisted Suicide

After the **patient's death**, the hospital is obligated to perform several at-cost steps postmortem in order to process the remains of a patient who died during his or her stay and deal with the possessions of the decedent. This includes the issuance of the death

[18]According to §1 I (4) FPV, a transfer constitutes a discharge from the sending hospital and an admission by the receiving hospital within 24 h.

certificate (if required, also with official translations) and performance of the post-mortem inspection. Also, costs can arise for the refrigerated storage of the corpse until a mortuary (normally hired by the next-of-kin) picks up the remains for further thanatological servicing. Under specific circumstances, the hospital might even have to begin the initial steps of thanatological processing ('carrying out the last offices,' such as those concerning corpse hygiene, or deactivation and recovery of implants). Logically, the hospital has to initiate a process to identify and bill the relatives or heirs for such services. As with involuntary patient admission, elements of classical contract formation like offer and acceptance do not arise here; therefore, the CM Approach likewise is not applicable.

From a financial liability perspective, the investigation into who will become heir of the decedent can become both lengthy and cost-intensive (cf. [15], p. 138). This is because the contractual role of the patient would be transferred the heir(s) upon the former's death. If the patient has left no testament (cf. [29], pp. 55–60), the hospital also has to administer the objects and possessions brought in by or with the decedent *in interim*.

Extremely particular legal ramifications arise if a terminal **patient declares intent to forego (further) treatment** and thereby knowingly accepts his or her death. As already introduced in Sect. 10.4.2.1, legal orders in the form of patient decrees such as Do-Not-Resuscitate (DNR) or Allow-Natural-Death (AND) notices, bar the healthcare provider from providing life-saving measures if specific medical conditions like cardiac arrest or cessation of breathing occur. Various legislation, such as the US Patient Self-Determination Act (PSDA) of 1990, give increasing specificity on this matter. With regards to risk and compliance management, the hospital should therefore attempt to verify the legal order. However, it should be kept in mind that medical practitioners, especially in emergency rooms or triage conditions, are both intrinsically and otherwise legally motivated to save lives and not engage in lengthy document verification procedures[19,20]. Nevertheless, in certain hospitals, the DNR might also be unilaterally declared by medical staff, regardless of patient consent. In such scenarios, doctors make the decision that further treatment is medically futile, such as when the patient is in a persistent vegetative state[21]. In either variation, the hospital contributes to the death of the patient, thereby ending his or her direct involvement in the contractual relationship. Such a mechanism likely cannot be found in any other industry.

Lastly, the trend that **assisted suicide**[22], as well as **active and passive euthanasia** become legal in more and more nations entails new considerations to both the service

[19]In many countries, procedural guidelines, such as the Canadian Joint Statement on Resuscitative Intervention exist to determine who should be involved in such a decision.

[20]While in Germany a database for patient declarations of intent does exist with the Federal Notary Chamber (*Bundesnotarkammer*), there are no legal obligations for physicians to consult these (cf. [29], pp. 66–67).

[21]For the US Supreme Court Case on such a scenario (see [44]).

[22]For a timeline listing of recent euthanasia legalization in various countries, please see https://euthanasia.procon.org/view.timeline.php?timelineID=000022#2000-present.

portfolio of hospital operators and the connection between partners that the contract is supposed to manage, even at the termination thereof.

10.4.4 Patient Discharge Management

After the treatment has been completed, it usually falls under the obligation of the hospital to organize the subsequent **medical care after discharge**. In Germany, social law (§39 Ia SGB V) makes this so-called discharge management mandatory in that—providing that the patient consents—a seamless handover to external service providers is to be organized by the hospital. Essentially, the hospital—under the authority of the attending physician and/or social service department (qualifying in accordance to §95 I (1) SGB V)—conducts several coordinating functions on behalf of the patient. Procedural guidelines are also predefined in the discharge management framework contract (*Rahmenvertrag Entlassmanagement*) which summarizes the hospital's social law obligations:

- Referral of patient and forwarding his or her medical record to external physicians, such as general practitioners or resident specialists.
- Selecting and awarding external service providers which will facilitate the seamless continuation of medical care. The latter must meet legal licensing requirements and be able to provide a service hotline.
- Providing an overview of the contracted service provider partners, including contact information, as well as contact information for its own discharge management hotline and website[23] (cf. §3 (7) Rahmenvertrag Entlassmanagement).
- Prescription of medications necessary for a duration of up to seven days post-discharge.
- Issuing certificates that could declare the patient as unfit to work or disabled.
- Coordinating with the patient's payor—in particular, the health and long-term care insurance (if applicable)—in order to determine coverage of necessary subsequent treatment steps (cf. §4 (6) Rahmenvertrag Entlassmanagement), as depicted below in Fig. 10.9:
- In particular, patient **aid equipment**, such as walking aids, hearing aids, orthoses, and protheses, but also consumables like bandages and incontinence products, often require a co-payment by the patient (§§33–34 SGB V). More complex equipment also will require periodic re-adjustment, maintenance, and, at the end of its lifecycle, replacement. This further increases the financial burden on both patient and payor.

[23]cf. §3 (7) Rahmenvertrag Entlassmanagement.

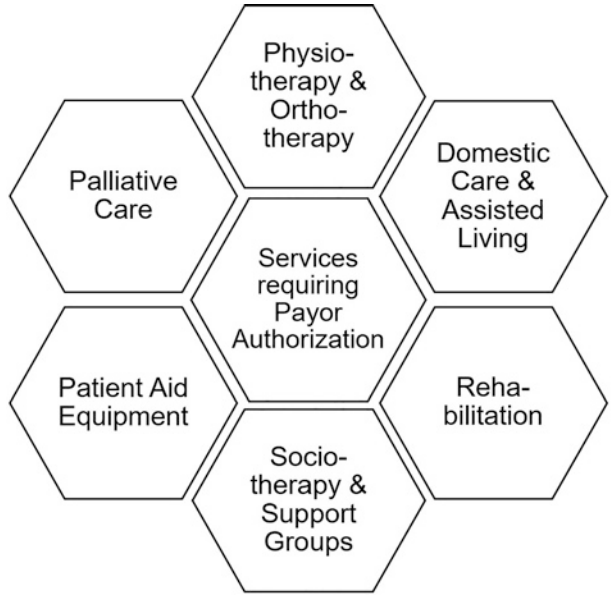

Fig. 10.9 Post-hospital treatment medical services

- Involvement of **domestic care** or assisted living providers is even more cost intensive[24] and in turn might also require long-term infrastructure investments in the patient's home, such as converting it into a barrier-free environment, or completely moving the patient to a specialized facility. In consequence, and mirroring the informed consent processes described in Sect. 10.4.1.2, discharge management requires written notification of the patient regarding the estimated costs of services that are initiated by the hospital.

It should be noted that the hospital has the complete mandate to award **contracts on behalf of the patient**. This includes determining any potential business partner's compliance with legal requirements and negotiating reimbursement. §12 SGB V establishes that the hospital is to follow the principle of general efficiency (*Wirtschaftlichkeitsgebot*) by awarding a contract scope that is economic (or in accordance to the compensation schedule if there is a fixed rate remuneration system for the particular service) and does not exceed essential necessity. In this regard, the hospital has to follow procedure established by the Federal Joint Committee. It is noteworthy, that the patient has no direct role in the selection of service providers in physical-, lingual-, and ergotherapy (cf. §4 (6) Rahmenvertrag Entlassmanagement), other than the ability to retract consent to the

[24]In several US states, the median annual cost for a single bedroom in an assisted living facility exceeds $70,000 per annum (cf. [30]). In Germany, even at the maximum care level, the co-payment of an average patient exceeds that of the basic long-term insurance plan (cf. [11]).

entire discharge management process. In parallel, the patient also has to give consent to the hospital to forward personal data to the external service providers. Furthermore, the patient must be given a chance to consult with relatives if so desired. If the patient is incapacitated or not of legal age, the responsible legal guardian has to give consent to the discharge management process.

The discharge management process culminates in a comprehensive document called the **discharge letter** which is handed over to the patient on the day he or she leaves the hospital (cf. §9 (1) Rahmenvertrag Entlassmanagement). The document, even if it is only in tentative form, is mandatory and includes the patient record, name and contact information of the treating hospital physician, reason for admission, primary and secondary diagnoses, test results, epicrisis & recommendations for subsequent procedure, medication plan, listing of all service prescriptions and the names of all contracted subsequent service providers, as well as the hotline for the hospital's discharge management department (cf. §9 (3) Rahmenvertrag Entlassmanagement).

All aforementioned procedures are governed in Germany by the **framework contract governing discharge management** for the transition into care after hospital treatment[25] which was reached by federal arbitration between the Federal Association of Public Health & Long-Term Care Insurances[26], the National Association of Statutory Health Insurance Physicians[27] and the German Hospital Federation and has been in effect since October 2017. With regards to the managerial steps, the framework contract's annexes 1a and 1b provide standardized forms which govern the patient informed consent notification, as well as the approval for the data forwarding to the service providers, respectively. While a framework contract is applicable to all patients leaving the hospital and the patient (after of course consenting to the discharge management process) is only intended beneficiary in the contractual construct between hospital and external service providers, it can be seen for all stages of the CM cycle, the relevant management fields of the CM Model are applicable here. Should indeed a discharge management involving these external business partners become necessary, it can then be stated that the hospital treatment—regardless of whether it was arranged based on a contract or public law special relationship—will still conclude with a contractual construct.

[25] *Rahmenvertrag über ein Entlassmanagement beim Übergang in die Versorgung nach Krankenhausbehandlung nach §39 Abs. 1a S.9 SGB V*, Az. BSA-Ä 1–16.

[26] *GKV-Spitzenverband (Spitzenverband Bund der Krankenkassen),* https://www.gkv-spitzenverband.de/ english/english.jsp.

[27] *Kassenärztliche Bundesvereinigung (KBV),* http://www.kbv.de/html/about_us.php.

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The PhilHealth Case—Health Care Contracts and Social Contract in Social Health Insurance

11

Maria C. G. Bautista

Contents

M. C. G. Bautista (✉)
Ateneo de Manila University, Manila, Philippines
e-mail: mcbautista@ateneo.edu

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Abstract

Two cases are discussed: the first is a simple health care contract, done in the context of selective contracting; and the second case explores the same contract as a social contract. It highlights the Contractual Management (CM) fields of planning, implementation, monitoring and evaluation for re-negotiation stages in the contract. The starting point is a selective purchasing model of care for complex medical cases in which a single payer no longer traditionally reimburses on fixed fee input-based items, but prospectively announces a package price, and providers express their interest in participating (designated as Z cases). When viewed in a principal-agent context, in which the funder is the principal and the contracted provider the agent, the issue of interest is finding the right incentives for the agent to pursue the principal's goal. An analysis of the cases presented herein, a contractual non-payment or delayed payment, highlights risks that could have been anticipated and addressed with a smarter contract management. The CM framework permits exploration of contract risks and an examination how improvements in the planning and process stages, including management of information and knowledge from the contract, can improve contract outcomes. The model presupposes flexibility of action open to private or business firms operating under strong institutions. However, the entities or contractual parties in the given case are both government agencies. With its management-based lens, the CM contract assessment highlights not only the legal aspects but also the social contract of state institutions assuring basic health care to the people. Contracting in this context

subsumes authority and compliance (the default modes of state institutions) with more 'learning by doing' or knowledge management, within the purview of Contract management. CM provides a pragmatic view of what it takes to bring out contracting's potential to transform the way health care is financed and delivered in the country.

Keywords	Z Benefit program, social health insurance, selective contracting, principal-agent context, social contract, social contracting
Principle management topic	Contracts in social context
Institution	Quasi-public, non-profit
Subject of management	Transaction, enterprise (here quasi-public institution)
CM process steps	Plan, implement, monitor, evaluate
Management fields	Risk management, management of transaction, knowledge management
Contract type	Service contract, health care contract

Editor's Note: For a full understanding of the CM Model's practical benefit for the case study, the reader may have to peruse at least sect. 1.4.4 and 1.4.5 of Part I. The keywords used above to characterize the area of contract application are explained in the key system preceding the case studies in Part II.

11.1 Challenge 1 (Provider's Perspective)

11.1.1 Set of Facts

The Philippines Health Insurance Corporation (PhilHealth or Funder) is the single social health insurance payer in the Philippines.

Explanation: Social Health Insurance
Social Health Insurance (SHI) is a form of financing and managing health care based on risk pooling. SHI pools both the health risks of the people, on the one hand, and the contributions of individuals, households, enterprises, and the government on the other. Thus, it protects people against financial and health burdens and is a relatively fair method of financing health care. For more on this topic see [1].

PhilHealth designed the Z Benefit program (or scheme) to pay, at a predetermined rate, for the substantive costs of 13 medical conditions which have dire or catastrophic financial and medical consequences (for example, common cancers, heart bypass, kidney transplants and the like). The Z Benefit program was established in June 2012 under PhilHealth Circular No. 029-2012, which described the Type Z Benefit cases, and was updated with Circulars 014-2015 and 035-2015 for implementation guidelines [2]. These circulars specify the type of cases and the processes for Z Benefit, from eligibility to reimbursement or payment for services rendered. The same circulars (available online) are

attached to the physical contract between PhilHealth and the health care facility (facility or Health Care Institution [HCI]) for each type of Z Benefit case covered for the facility.

PhilHealth is committed to paying for Z Benefit cases following the satisfaction and assurance of the following:

1. Its sponsored or indigent members will be on a No Balance Billing basis; non-sponsored members may be charged out of pocket but not higher than fixed proportions, based on the income of members;
2. The facility has been inspected and is authorized to offer service to members;
3. Treatment for No Balance Billing patients commences after eligibility and pre-authorization check with PhilHealth;
4. Diagnostic stage, classifications and medical protocol adhere to the standards identified in the respective forms, with a Multidisciplinary Team fully on board; and,
5. Patient signs off at all stages, including at the start, that he or she understands the No Balance Billing, that he or she is aware of the medical team approach and that he or she fully undertakes to comply with the medical management of the case and provide feedback at the end.

Three things stand out that distinguish the Z Benefit contract from regular PhilHealth reimbursements: Firstly, facilities that are contracted to provide Z Benefits cannot bill or impose additional user charges on eligible patients—a common practice in both private and public facilities in the country—as their authorized condition is covered by the scheme. Since Z Benefits cover high-cost cases, benefits are free of charge for members under the government Conditional Cash Transfer (called 4Ps) scheme and for indigents. A fee, capped as a proportion of the overall case fees, is allowed to be charged for members who do not belong to sponsored families in the government scheme. Secondly, the medical procedures, from diagnosis to discharge, follow specific protocols with full documentation of these highly complex cases so that quality of care is assured; and, thirdly, the program has a strong focus on patient empowerment (or member empowerment) and mandates facilities to fully engage with patients, providing them the right information and support, including filling-in empowerment and satisfaction forms.

P-Medical Center (P-MC or Provider), a tertiary level hospital, is a regional and non-devolved government-owned facility located 159.7 km from Manila, which has been accredited to provide the breast cancer package for the Z Benefit program. Breast cancer under the Z Benefit scheme is reimbursed at PHP 100,000 (Euro 1972). P-MC is a 400-bed facility with 78% of its total manpower of 1250 personnel providing clinical services, including medicine, ophthalmology, surgery, pediatrics, anesthesiology, obstetrics & gynecology, orthopedics, radiology, and health emergency management services. It serves a population of about 283.7 thousand people (in 2015) and an estimated 700,000 families identified as poor by the government cash transfer program.

P-MC was authorized under the Z Benefit program in September 2013 for three cases—leukemia, prostate and breast cancer, although only breast cancer cases proceeded to implementation. It received a total reimbursement of PHP 400,000 (Euro 7890) from 2013–2015 for five Breast CA (cancer) cases covered under the Z Benefit program as the first tranche reimbursement for the five cases.

P-MC has not received reimbursements on cases treated after 2015 despite having treated cases for some 19 breast cancer patients for 2016–2017. Requests for payment are still current up at present, more than two years since the last reimbursement. Insufficient documentation was cited by PhilHealth as the reason for non-reimbursement referring to the Z-contract which states a no-return to sender policy in terms of documentation.

After P-MC's contract for Z case breast cancer lapsed in June 2017, as per telephone communication from PhilHealth, P-MC filed a Letter of Interest (LOI) to continue the program in July 2017. As of April 2018, the authorization for Z Benefit coverage for P-MC has not been given.

P-MC's Z Benefit Coordinator now needs to consider what he can do with respect to the two issues—pending payments and renewal of provider contract.

11.1.2 Operating Procedure

11.1.2.1 Author's Explanations

The provider contract concluded between P-MC and PhilHealth is considered here to highlight the CM process step implement under the transaction phase of the PhilHealth Z-Benefit management process. The facility coordinator, the Z Benefit Coordinator, was awaiting more than just "insufficient documentation" as an explanation for contract termination, highlighting communication as a critical management function, even at the pre-implementation stage, for any transaction. He has to find out what the reasons were for the discontinuation of Z Benefit coverage and identify options now that 19 cases have been undertaken. Eligibility checks and Member Empowerment Forms are critical for the Funder, i.e. PhilHealth, just as providers have to make sure the medical stage or classification fits into the Z Benefit classification. For breast cancer, it would be early stage that will be considered for reimbursement. Thus, patient and provider management systems are crucial in this multi-party transaction.

Under the CM Model, the contract is an instrument for managing the relationship between P-MC and PhilHealth: for information, for action, to measure compliance, and for claims reimbursement. The CM Model takes into consideration the Contractual Management circle from planning through evaluating, including embedding decision processes, like renewals, assessments on re-pricing, and expansion to other conditions in the management landscape. For a program like Z Benefits, decision processes rest largely on the management systems around the contract.

11.1.2.2 Reader's Tasks

Take the position of the P-MC's Z Benefit Coordinator and process the tasks below:

Task 1: Make a decision how to proceed with the 19 pending cases before the contract lapsed in June 2017. (Level of difficulty: Medium).
Task 2: Make a proposal how to proceed concerning the renewal of the Z Benefit contract. (Level of difficulty: High).
Task 3: Make a proposal regarding the coordination of facility level responses. (Level of difficulty: Low).
Task 4: Deduce possibilities for the optimization of P-MC's internal processes. (Level of difficulty: Medium).

11.2 Decision-Making Process

11.2.1 Decision Regarding the 19 Pending Cases

Task 1: Make a decision how to proceed with the 19 pending cases before the contract lapsed in June 2017.

11.2.1.1 Quest for Knowledge or Information

Is P-MC legally entitled to payment or not? The P-MC's Z Benefit Coordinator first has to check the contract concluded between PhilHealth and P-MC. The relevant contract stipulates under Article V, section 1 that PhilHealth shall reimburse P-MC according to the rates and schedules enumerated in PhilHealth Circular No. 30-2012.

The said circular, however, gives PhilHealth the right to deny payment in the following instances:

1. Mandatory service was not provided by the contracted health care institution;
2. The required signatures in the forms are missing;
3. Forms have been incompletely filled out;
4. Attachments, such as Member Empowerment Forms, Z Satisfaction Questionnaire, photocopy of completely accomplished Breast Cancer Medical Records Summary form for second tranche of Z Benefits for Breast CA, original copy of Pre-Authorization Checklist and Request, or any other forms required under the Z Benefit program are incomplete;
5. Late filing.

Issues for incomplete documentation as communicated to P-MC fall under clauses 2–4 above. The documentation requirements for Z Benefits are very extensive. The PhilHealth Benefit Eligibility Form is manually written, including a YES and signature from PhilHealth needed in the document. The contract states that PhilHealth will return

the authorization on eligibility of patient-member within two days. This has not been the case, with the turnaround time for **pre-authorization** a sticky point mentioned in communication. In our case, the approving authority, PhilHealth Regional Office, is physically located 93.9 km from P-MC. Manual evaluation of claims is undertaken.

The **No Return to Sender policy** of claims evaluation for Z Benefits is specified in the contract. This is a risk that, under the CM Model, falls in the purview of better planning and setting up of systems for client management, given that the priority intended population for Z Benefits are those considered indigent and may be from geographically isolated areas. There are weak mechanisms for appeal in the system in general, as well as for Z Benefits, the completeness of submitted forms and the No Return to Sender policy are emphasized in sub-clause IX-C, Circular 035-2015. The Local Health Insurance Office and the PhilHealth Regional Office have the prerogative not to accept incomplete documents. These offices though can directly coordinate with the provider regarding the deficient documents and can re-submit 'within the required filing schedule'.

11.2.1.2 Options of Action

On the basis of its contract, P-MC can file for a **Motion for Reconsideration** on the denied claims based on PhilHealth policies. However, with the specific documentation requirements listed in the contract, the motion would be unlikely to progress, unless P-MC can assure that all boxes have been ticked and all signatures secured for every procedure undertaken for the patient listed in the form, including the signatures of patients who have undergone such difficult and stressful treatments and many of whom are likely living some distance from the facility. PhilHealth's general policy on Motion for Reconsideration (contained in Circular No. 03-2008) specifies a 15-day window for providers to appeal any written denial of claims from PhilHealth. With such written denial, the P-MC Coordinator has to retrieve from their records all documentation to review whether Z Benefit claims can be appealed. PhilHealth has 30 days from receipt of claims filed to respond. Without written denial from PhilHealth or an explanation as reported by P-MC, there is no recourse for appeal.

The P-MC Z Benefits Coordinator can look into the **filing of the Breast CA cases as regular cases** under case payment, provided they are within the period for filing and are not considered lapsed. This means the facility would get paid separately for each procedure undertaken (i.e. surgery, chemotherapy, etc.) and not bundled as Z Benefit Breast CA package. It would be less than the amount they could get reimbursed under Z Benefits, estimated at around 40% of the Z-Package. A total loss can thus be avoided.

On the basis of contract remedies and considering that P-MC and PhilHealth are both government agencies, **bringing PhilHealth to court** will likely not be an option unless financial auditors of the government advise them to do so. As a Department of Health facility, the case has to be taken up through its central office. P-MC does not have a lawyer in its plantilla and requiring such professional service may need the Department of Health's approval. The Secretary (Minister) of the Department of Health is the Chairman of the PhilHealth Board.

11.2.1.3 Options' Pros and Cons

The Z Benefit contract states the recourse available to the facility for payments under the contract. Filing as a regular case and not under Z Benefit could avoid a big loss but would not have assurance of approval as time limits may apply. This state of limbo has often occurred in cases of non-reimbursement for the Z Benefits. Explanations have not been forthcoming and facility administrators can only follow up at the PhilHealth Regional Office. As of yet no court case has actually been filed and it would also not be in keeping with the Philippine organizational culture, characterized as "not only hampered by conflict avoidance, but also by inadequate social mechanisms for conflict resolution" [3]. However, without a written denial, there is a case for the reimbursement process being just delayed.

11.2.1.4 Decision

Since no written denial of claims has been forwarded by PhilHealth, a Motion for Reconsideration by P-MC on delayed payments is not time barred and can still be appealed for; if the motion fails, cost can be recovered by filing as regular cases.

11.2.2 Proposal Whether to Renew the Contract

Task 2: Make a proposal how to proceed concerning the renewal of the Z Benefit contract.

11.2.2.1 Options of Action

According to the contract, renewal of the Z Benefit contract is automatic and does not require any action as long as all the regulations are being followed. However, with non-reimbursement, facility administrators interpreted this to mean that an **Expression of Interest** (EOI) will need to be filed. To this end, P-MC has already filed a Letter of Intent, which is not to be mistaken for the Expression of Interest. Provided they are still interested in participating, the key decision-makers at this point will be the surgeons and specialists who have not been reimbursed according to the normal course of program implementation. In our case, it appears they were prepared to file for an Expression of Interest.

An option for P-MC in general is to examine its systems and foresee their capabilities in terms of **other conditions that can be covered by Z Benefits**. To express interest in straight surgery cases (like colorectal cancer, or heart conditions) would be an option as it is not heavily dependent on patient follow-up and is a single transaction after surgery. Aside from capacities, a key consideration will be whether patients will be willing to use P-MC as their provider of choice or whether they may want to go to other facilities, albeit farther away. Thus, patient volume could be a factor in a successful Z Benefit implementation.

In either case, filing for an Expression of Interest for the existing Breast CA or for new conditions will mean the start of the process of accreditation and inspection of facilities, which can take anywhere from 6 to 8 months.

11.2.2.2 Options' Pros and Cons

Cumbersome processes After being informed about the lapse of the Z Benefit contract in June 2017, P-MC filed a Letter of Intent in July 2017. It will have to undergo another EOI and another inspection, specifying its capacities and services available for Breast CA. There is no clause in the contract that states that payables can be carried over in the case of a lapsed contract. The contract was automatically renewed for three years beginning 2013, and a communication (albeit by telephone) on its lapse was made only in 2017. However, reimbursements ceased starting at the end of 2015.

As of April 2018, there has been no progress on the Letter of Intent submitted by P-MC. This needs to be followed by the EOI, which is a tick-box of its different capacities. PhilHealth has been slow acting on the matter and P-MC's case is similar to other cases involving government hospitals under the Department of Health. There are likely to be more discussions and negotiations taking place between PhilHealth and the Department of Health regarding its public facilities. The EOI, as a trigger for discussions to contract, is a tool for self-selection into the program and not a competition. PhilHealth does not out to select a potential partner to contract for Z Benefits. In a way, this highlights that, for PhilHealth, this is not a procurement system which is subject to the long drawn-out processes of advertising, demonstrating technical specifications and capacities, and more particularly, stating the costs by which services will be delivered, and for which selection is often based on being a low-cost bid. The specifications are already stated in the circulars, including the costs at which these services will be billed. There is little to no bargaining cost involved. It is only after receipt of the EOI that PhilHealth conducts its regular processes of determining capacities in terms of personnel (including their training and certifications), facilities and equipment. However, if a facility submits its EOI, it has already studied all the requirements and is confident about meeting these requirements, so the inspection by PhilHealth should not take long nor possibly be thorough. The fact that no private facility has expressed interest in delivering Z Benefits shows that it does not make business sense for them. Since public facilities are the main providers of Z Benefits, motivation for program participation stems from considerations other than the market, such as status, supplemental income, authority or political pressure. As the contractual partners here are government agencies, government ethos is likely to prevail, including cumbersome and bureaucratic systems, from both sides.

Investments undertaken P-MC has heavily invested in the Z Benefit Breast CA requirements. A key aspect of the Z Benefit Package is having a Multidisciplinary Team for Breast CA cases. This is the same team currently that started the program and is keen to carry on the coverage for the Z Benefit Package. The Expression of Interest inspection for the first Z Benefit year, 2013, seemed to have overlooked P-MC's not having a specific facility or room for chemotherapy, as this reason was cited for P-MC's non-coverage of tranche 2 for Breast CA cases under Z-Benefit. P-MC has put up such a dedicated room by 2015. Moreover, the Z Benefit contract recognizes that some contracted

institutions may not have full personnel and equipment fully in place for complex cases which is why sub-contracting between facilities can be authorized. However, the contract between the facilities must be provided to PhilHealth.

Competition There is one other public hospital facility in the region that is authorized for early Breast CA, but it is outside the province where P-MC is located. This other regional facility is also much closer to the PhilHealth Regional Office; hence, there may be no pressure on the part of PhilHealth to act on P-MC's new Z Benefit application. For Breast CA patients with PhilHealth membership, this will be an added burden as they will have to travel 86.4 km to get there.

11.2.2.3 Proposition

P-MC's Z Benefit Coordinator will suggest continuing to follow up, inquire, and negotiate for the continued operation of Z Benefit with improved planning and incorporation of lessons learned.

11.3 Implementation of the Decision

Task 3: Proposal regarding the coordination of facility level (P-MC) responses.
More than two years have passed since P-MC's last reimbursement from the Z Benefit program, though not yet a year since its notification of the contract lapse. Difficulties of coordination, arising from the physical distance between the offices involved, as well as the very manual or non-electronic adjudication involved in the Z Benefit program, entail that moving forward will require some risk mitigation efforts.

11.3.1 Internal Implementation

Prior to a dialog with the PhilHealth Regional Office, P-MC's Z Benefits Coordinator needs to discuss with his administrator and the Multidisciplinary Team whether they will go ahead with lodging a new application for early stage Breast CA. There are two main issues to be considered:

- **Whether to lodge an application for Breast CA** or some other case in the Z Benefit list: It is still an open option as they have only thus far signed a Letter of Intent and have not filled-in an Expression of Interest. Cases of early stage Breast CA will require an extended period of time because of the treatment pathway, and therefore involves payment tranching. The specificity of the stage of cancer is quite problematic from a patient management perspective as it can be emotionally draining to explain to someone with late stage and serious case of Breast CA the non-coverage of their case

under the Z Benefit program. The facilities necessary for complete treatment, like a dedicated room for chemotherapy and radiotherapy, can be quite expensive and, while subcontracting is allowed under the Z Benefit scheme, it can still involve the transaction costs of subcontracting (e.g. drawing up a contract with the facility, showing a copy of the contract to PhilHealth, timely payments to the subcontractor, and for the patient, inconvenience in dealing with another facility). The cost of radiotherapy is also not included in the Z Benefits Package, but can be lodged under regular case payment.

- **How to organize payment processes**: The Z Benefit program involves a different payment modality with PhilHealth which can be quite confusing at the operations level. Forms, processes and procedures are specific to medical diagnosis and pathways. Whatever benefit package P-MC will apply for cover under the Z Benefit program, they will need to invest in some **knowledge acquisition** by getting briefing and demonstrations from the relevant medical society and ensure a study visit to another facility handling the relevant cases, which is an essential part of the process according to the CM process steps plan and implement. P-MC needs to institute patient support and educational activities not only among patients but also among staff, including support staff.

11.3.2 External Implementation

P-MC's Z Benefit Coordinator, jointly with the Multidisciplinary Team, will need to convene a **dialogue with PhilHealth** to determine: (i) if filing a motion for reconsideration for denied payment still needs to be made for the 19 cases, in which case it is a matter of waiting for the payment; and (ii) if the 19 cases can still be applied under the direct case rate payment despite the time that has passed? If there is no remedy of an appeal, he may consider case rate payment as this has less stringent requirements. The Z Benefit contract states that if members were ineligible for Z Benefit, they can be shifted to the regular case payments, so clarification on this point is necessary as some time has already elapsed.

Since issues relating to capacities are likely to be raised, the Z Benefit Coordinator should examine the possibilities of **subcontracting** the other regional center, so that diagnosis and surgery are undertaken in P-MC and the follow-up takes place at the regional center. At the same time, he must continue to intensify contact with the PhilHealth Regional Office. As per the Z Benefit contract, a subcontract is allowed. Everything will need to be in writing.

Given this unique opportunity of face-to-face dialogue with PhilHealth, P-MC can discuss how to **improve coordination with the PhilHealth Regional Office**. Preauthorization on the eligibility of patients must be done within the time stipulated in the contract. Alternative means can be agreed upon should the approving officer not be available at the time a patient is diagnosed for treatment. P-MC can participate in any

educational opportunities such as an observation tour by its Z Benefit Coordinator and other staff involved in the Z Benefit program to other facilities with longer experience in delivering treatment and care for Z Benefit Breast CA cases. Such acquired knowledge will improve the planning and implementation of the scheme in the P-MC to prepare for proper implementation and to avoid costly lessons under the new contract, once signed.

On the basis of the contract, P-MC can provide input at the **Policy Review** stage, as identified in Article XII of the Circular 035-2015, the 'Principles' document attached to every Z-Benefit contract. The Policy Review is a process where stakeholders share their experience and gaps in the implementation of Z Benefits. Participating facility representatives, experts and technical staff from the Regional Offices of PhilHealth review the whole benefit package with the goal of enhancing benefits, adjusting rates and expanding scope. This is the forum in which providers can bring up any complications encountered in the implementation of the program, requiring further adjustments or even subsidies. The contract specifies that this Policy Review is initiated by PhilHealth.

11.4 Process Optimization

Task 4: Optimization of P-MC's internal processes.

11.4.1 Risk Management

A systematic approach to implementation risk appears to be the most appropriate instrument to avoid incidents as encountered in our case by P-MC as well as by PhilHealth.

11.4.1.1 Implementation Risks

- **Debt default risk**: The consequence for the non-payment of cases that occurred under the Z Benefit Breast CA package is estimated at EUR 37,475. Unless some of the amount can be recovered by the filing of the Z Benefit cases treated under the regular case rate reimbursement, this is a loss. However, as a government facility, P-MC still has government budget allocations that will sustain the facility and allow it to continue delivery hospital services. At least 7% of its EUR 21.5 million government allocation in 2017 went to charitable cases involving No Balance Billing and discounts or partial support. More crucial for Z Benefit providers getting paid on time is their ability to secure the resources needed for quality delivery. The Z Benefit scheme is specific on procedures and medication and the ability to deliver these services for patients. Given the No Balance Billing clause, such ability is dependent on well-planned and timely purchases or procurement of the needed medicines and inputs. Z Benefit payments are top-up to limited budgetary allocations from the government. In case of any shortfalls in supply of essential medicines and reagents, the funds from Z Benefit payments can be used.

- **Motivation risk**: Non-payment or late payment affects the additional professional fees and thus may impact morale of the personnel. However, the re-filing for Z Benefit coverage with the Letter of Intent indicates that the medical staff still supports the program. The Z Benefit contract assures the staff that services rendered, particularly for patients they cannot charge directly, will be reimbursed under the scheme.
- **Process risk**: The Z Benefit scheme is unlike other coexisting PhilHealth programs because of its higher reimbursements for catastrophic cases, but it is also heavy on documentation requirements. The reliance on hard copies and manual transfers of documents between offices embed risks arising from misplacement and/or loss of documents, leading to delays in approvals and reimbursements.

11.4.1.2 Risk Treatment

Due to the long-term dealings of the providers with PhilHealth, from its inception as a social security institution to a health insurance agency, there are some mechanistic responses to its rules and procedures that may have survived due to relationships developed with scheme implementers. With Z Benefit however, its focus on patient-centered care, with Member Empowerment Forms, deliberate team effort in the treatment and care for early Breast CA, the emphasis on financial protection and quality with the strict adherence to clinical standards—all these features require more than the usual claims processes with PhilHealth. The P-MC Z Benefit Coordinator must review their systems to determine the hindrances to smooth contract implementation. Management systems like patient management, case management and claims management can be improved based on the lessons of the failure of the previous contract.

P-MC's ability to secure No Balance Billing, or not charging for PhilHealth's Z Benefit eligible members, can be situated within the purview of the CM Model's management field knowledge management. As a provider, P-MC must know its true costs of service provision and maintain suppliers' commitment for prompt deliveries at steady prices for it to continue being able to provide a particular service at the price for which it will be reimbursed.

11.4.2 Other Optimization Actions

A CM Model perspective highlights the importance of other actions needed for optimal contracts.

- **Information utilization and access** relating to the CM process steps monitor and evaluate as well as to knowledge management: It is essential to invest early in a population-based information system like the one in Taiwan that links membership data to members' utilization and claims data. This allowed Taiwan to develop the research capacities to nurture staff and students to gain graduate degrees overseas and to use health insurance databases for performance analysis. The benefits of knowledge

management create the evidence needed for reforms and policies. In contrast, the indemnity type of insurance for conservative social security management for the formal sector was the path followed for PhilHealth (a kind of path dependency).
Taiwan, on the other hand, only needed two years to cover 96% of its 21 million population under their National Health Insurance program [4]. The striking feature in the Taiwan system is that its National Health Insurance program is compulsory while the **Philippines started as voluntary scheme** for 68 million citizens when it was established. Three quarters of jobs in the Philippines are informal and 50% of informal workers are wage workers, without contracts and social security [5]. It is not to be taken for granted of course that the Taiwanese solution would also work in the Philippines, since it was built in a period of export-led economic growth in the 1980s and remained politically stable, while the Philippines' economy and politics have been more turbulent.

- **Need-based contracting** relating to the CM process steps plan and draft: Local needs identification is a starting point for selective contracting. The funder, PhilHealth, purchases health services for its members ideally based on their health needs. Differences in needs and risks exist, thus geographical location needs consideration. Risk-based modeling will allow anticipation of expenditures with thresholds identified for distributive allocations. The CM process steps plan and draft can help to incorporate the relevant responsibilities, with performance targets set and based on meeting needs.

11.5 Actual Execution

Update June 2018: PhilHealth has updated and paid its arrears on the 19 cases to P-MC following the meeting between P-MC administrators and PhilHealth regional team.

The Z-Benefit contract with P-MC will be renewed for 2017–2018, with the *proviso* that P-MC increases their enrollment of members. The decision to renew, with additional conditionality of enrolling more members into the Z Benefit program, has been accepted by P-MC. Without the broader Policy Review indicated in the contract, the internal or external preparations mentioned here remain relevant.

11.6 Challenge 2 (Societal Perspective)

11.6.1 Set of Facts

For much of its existence since 1995, PhilHealth has provided members only a modicum of financial protection as hospitals, both private and public, can still charge patients beyond what PhilHealth covers. These issues have put political and international pressure on PhilHealth, given the global thrust for universal health coverage—mandating universal access of the population to health services that do not impose catastrophic

medical costs to families by way of greater insurance coverage with reduced and zero (for the poor) cost sharing or out of pocket payments.

The Z Benefit scheme is PhilHealth's answer or response to problems raised by critics as follows:

- The perennial complaint from members that the Fund was **paying 'too little'** of the costs of treatment [6]. The Circular establishing the Z Benefit package mentions that support value has been hovering around 30% of the patient's costs for much of the nearly two decades of implementation. Patients bear the extra charges above PhilHealth payments. The 2016 support value in PhilHealth's online charts show an estimated (not actual) 50% support value. However, the data is based on reported household spending from the Demographic Health Survey for 2013 and compared to average pay-outs by PhilHealth with some adjustment for inflation.
- There have been reports on the lack of financial protection but **large Fund reserves**. The Fund has managed to maintain low loss ratios (spending against premiums earned). PhilHealth remains solvent and has accumulated a large surplus with US$ 1 billion in assets in 2007 [7]. From 2004 to 2009, the Fund reserves were three to four years' worth but were reduced to close to two years by 2013, as per the Fund's mandate [8]. High reserves denote less spending (for benefit payments or operating expenses) and this would not be politic to hold on to, given the low benefits for the members. Recent newspaper reports however indicated that PhilHealth was on the red since 2016 with a net income loss of PHP 252.5 million (EUR 3.9 million) and with a loss of PHP 8.92 billion (EUR 138 million) in 2017.
- Philippine health service delivery operates largely on a fee-for-service basis, with a large private sector component (60% of facilities in the country are private). The facilities can charge whatever they want and encourage patients to appeal to all sources of funding outside of PhilHealth and the supplemental private insurance for those employed in large firms: for example, appealing to relatives, lottery monies, charities, and politicians. This encourages the **inflation of health care costs** and promotes supplier-induced demand.
- **Utilization by vulnerable populations is low** and the impact on health outcomes barely discernable. No major strides have been made in changing the disease profile in the country, and many of the health goals in the Millennial Development Goals for 2015 remained unmet [9]. A more updated review of the Philippine health system is contained in the recent Health in Transition Series of the Asia Pacific Observatory on Health Systems and Policies [10].

Z Benefits form part of PhilHealth's response to these challenges, albeit one which has yielded cases such as P-MC, with a low uptake of providers and a 'carve out' of few cases by a handful of contracted facilities. It continues along the path academicians have called "having a little for everyone," following along the same path for 22 years as PhilHealth and 27 years before as Medicare.

In light of such criticism, PhilHealth's Policy and Review unit has been requested to prepare suggestions for the further development and optimization of the Z-Benefit program for presentation to the Board. The unit has established a multi-sectoral working group to examine proposals.

11.6.2 Operating Procedures

11.6.2.1 Author's Explanations

This case study involves two government agencies with PhilHealth being a government corporation and P-MC a public hospital. Staff members in both agencies are considered civil servants. The case as presented from two perspectives highlights contract failure due to inattention to contract risks, capacities and issues related to state administration and bureaucracy as well as hampered communication and responsiveness. Understanding the behavior of government functionaries, or civil servants, brings to the fore the basic question of the relationship of government or state to society. This allows us to view the complex funder-provider relationship in SHI as a **'social contract'** and brings us to the nexus of the state-society relationship.

Contract Knowledge: Social Contract and Social Contract Theory

"The social contract refers to processes by which everyone in a political community, either explicitly or tacitly, consents to state authority, thereby limiting some of her or his freedoms, in exchange for the state's protection of their universal human rights and security and for the adequate provision of public goods and services. This agreement calls for individuals to comply with the state's laws, rules, and practices in pursuit of broader common goals, such as security or protection, and basic services. The validity and legitimacy of a social contract may be gauged by the extent to which it creates and maintains an equilibrium between society's expectations and obligations and those of state authorities and institutions, …" [11].

Based on the works of 17th and 18th century philosophers, namely Hobbes, Locke and Rosseau, social contract theory (SCT) evolved from the liberal and individualistic view of the state functioning to protect property and maintain order, to one where the social contract reflects adherence to human rights and social justice. Modern contractarians are associated with the latter view, its foremost proponent being John Rawls.

SCT has been used analytically to discuss self-regulation among professionals [12] and towards health professionals [13]. It has been invoked during deliberations on the Affordable Care Act which mandated widespread health insurance coverage in the United States [14]. Long-term care reforms in Japan are also viewed within the social contract framework where 'everybody contributes' [15].

For **further reading** on the social contract, see [16], pp. 392–398 and [17].

The **social contract** in SHI can be viewed as equilibrating various interests in such a way that no group can appropriate or misappropriate the SHI funds for their sole benefit, and that resources will be spent only for the financial protection provided to the population, both contributing and dependents, in their eventual health care needs. Using the 'metaphors of social contract theory' [17], the set of facts in this case (see Sect. 11.1.1) may highlight the 'state of nature' in the Hobbesian sense: one of inefficient and inequitable SHI performance.

The social contract for SHI is one in which the 'state of law' can be similarly expressed in the Z Benefit contracts and the universal health coverage ethos: a wider population coverage, particularly of the poor, with quality health care services as one of the basic rights protected by social contract, with as much support as possible from the SHI funds through capped and/or zero co-payments.

To consider SHI as a 'social contract', the standard model of the World Health Organization (WHO) for Universal Health Coverage (UHC) can be taken as a point of reference (see Fig. 11.1 below). UHC has three elements: health cost financing, health services provision and population coverage. The 'coverage cube' highlights essential elements to achieve universal coverage of the population, with access to the health services they need and with adequate financing support to avoid falling into impoverishment, which a private contract between an insurer and member may not be able to provide. Social contracting entails that the state, including providers, have responsibilities to safeguard the funds to benefit as many of the population as possible, particularly in those times of need when health treatment can lead to financial catastrophe for individuals or families. For much of its existence, PhilHealth was limited in terms of financial cover, population share and covered

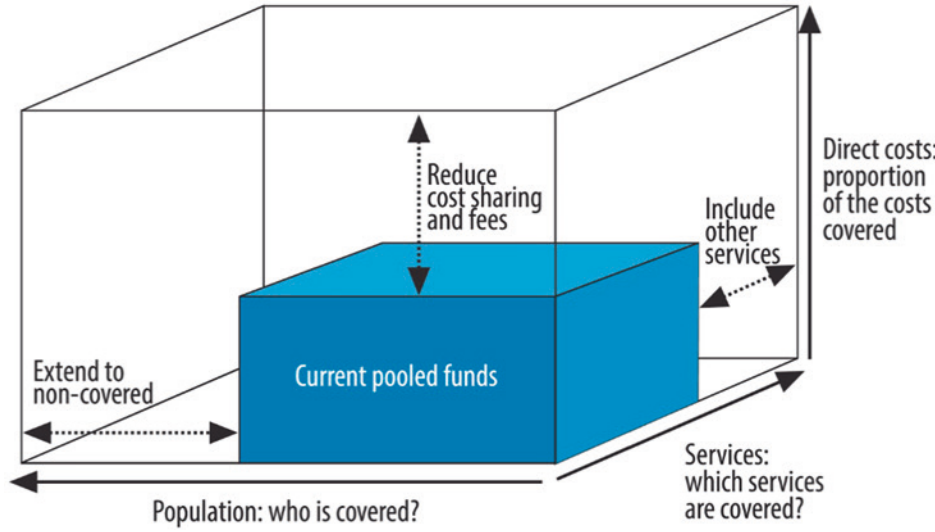

Fig. 11.1 The three dimensions of universal health coverage [18]

services. The Z Benefit program promises to produce the financial and service delivery commitment, providing universal access to quality health services at a lower financial burden, or even for free for the poor. With 92% population coverage and tax revenues combining with members' contributions in the pool of funds, the move to UHC is akin to a social contract, where the insured are guided to providers who enter into contracts to deliver the services at the quality and price in the contract, with no extra charges for the poor.

11.6.2.2 Reader's Tasks

You are a member of PhilHealth's multi-sectoral working group. Address the following issues:

Task 5: Identify the features characterizing SHI contracting in the Philippines. (Level of difficulty: High).
Task 6: Make propositions to optimize contracting for Z Benefits. (Level of difficulty: Medium).

11.7 Preparation of the Proposition

Task 5: Features Characterizing SHI Contracting in the Philippines.

11.7.1 Perspective: From SHI to Universal Health Coverage as a Social Contract

Transforming from a 'state of nature' to a 'state of law' for universal health coverage, i.e. creating a social contract, entails understanding the expectations and obligations that the institutions of the state have to the society at large. In the present case, this means collecting and safeguarding the SHI funds, and seeking a balance of current expenditures and future funds sustainability in order to meet the health care rights obligations of the state. Universal health coverage is possible with improved efficiency and responsiveness, choice and equity. This section discusses how the Z Benefit contract has addressed concerns in the literature of whether contracts can make for efficient outcomes, that is, for meeting the greatest health needs at the minimum cost. The next section discusses choice and equity.

Social health insurance is unlike other private contract settings simply by the large number of stakeholders involved—members, providers, organizations and funding. It is a complex web of relationships, which from a **principal agent perspective** can be viewed as insurer-member, insurer-provider, provider-member and other internal relationships (fund manager-operations manager). Many will be covered by contracts, though some may not be explicit, such as doctor-patient relationships or internal labor relations. Z Benefit is an explicit contract between PhilHealth and the provider.

Contract Knowledge: The Principal Agent Model

A principal-agent relationship is said to exist when someone (principal) requires another (agent) to undertake an action or decision that the principal prefers. This is normally done through a contract; hence principal-agent is a specific area under contract theory. A common application describes the relationship between a patient (principal) and a provider (agent), or a public funder (principal) and service provider (agent). Underpinning this relationship is the fact that the principal does not possess the same information as the agent (asymmetric information) and that this impacts each one's actions or decisions. Conceptually, the central concern is for the principal to structure a system of incentives that will make the agent undertake its objectives, given various institutional settings. It is the principal's task to make it worthwhile for the agent to undertake the desired action (incentive compatibility) [19].

Anticipating these actions in the face of information problems and previous actions provides a model like a game, hence its application in game theory. Costs or losses occur in the difference between what the principal is able to elicit from the agent given this incentive compatibility constraints and what it would have spent if it had the information and capability as the agent. In the context of institutional arrangements, [20] cited Transaction Costs are determining the decision whether to integrate (as a firm) or to seek outside the firm (in the market). As part of the policy movement of making public institutions more efficient and responsive, quasi-market discussions in the UK in the 1990s set the model in evaluating its potentials and limitations. Le Grand and Bartlett [21] apply this framework for early assessments of the UK's foray into contracting and Roberts shows different applications in various infection control operating environments [22].

Uncertainty and imperfect information challenge contracts as they limit the ability to plan ahead and specify for all contingencies. The **'unobservability of quality'** is associated with the negative consequences of contracting, like in fixed price contracts, especially when only a general statement of quality in services is specified [23]. The Z Benefit contract cannot be faulted for its anticipation of quality of care issues. It practically specifies the processes and technology of care that it deems its agents should perform for the benefit of Z eligible members. Improving care quality is one of the expressed objectives of the program. PhilHealth has drawn up the protocols for quality care of the high cost conditions covered by Z Benefits in partnership with the different medical specialists' associations. With the technology or processes indicated, the challenge to the provider is being able to deliver the services at the price it will be reimbursed for. If the processes are fairly new, there might be room for adjustments and 'learning by doing', for which prompt reimbursement would be encouraging and motivating to providers. Motivation is one condition cited that makes contracting worth doing [21].

11.7.2 Between Passive and Selective Contracting

Contracting is the main tool for selective purchasing. Contracts define the relationship between purchasers (as principal = funder) and providers (as agents). For procurement of a single public health insurance agency, two modes of contracting can be distinguished: **passive and selective contracting**. The Z Benefit scheme is PhilHealth's significant effort at selective contracting. By selective contracting, some consumer choice is limited; with access limited to accredited and contracted providers and to selected vulnerable populations as a social justice means. However selective contracting allows for prioritization of conditions, in the case of Z benefits, coverage for the high cost conditions which are prevalent causes of mortality.

Contract Knowledge: Passive and Selective Contracting
Passive contracting involves the purchase of a service or good much like any other product: purchasing what is available. For health care in the Philippines, as a system organized around a single payer or purchaser, there is an interest in moving from passive to more proactive or strategic purchases. Such **selective contracting** is one that considers what services to source, how and from whom to purchase in light of the population health care needs and limited resources of a country like the Philippines. Health service contracts involve lengthy service specifications, undertakings, claims filing and reimbursement schedules, monitoring and reviewing of performance and re-negotiations [24].
For **further reading** on SHI contracting, see [25] and [26], pp. 33–61.

Contracting in health care in particular and social services in general is not the traditional view of the state which undertakes provision of services on its own. Contracting in the public sector is unlike ordinary state procurement with tangible and storeable deliveries. Instead, contracts in health and social care use payments as incentives to achieve desired social outcomes. Incentives, rather than authority, are viewed to counter bureaucratic malaise and improve social service governance. Where services are often delivered by state agencies, a large organization will develop, relying on rule-based behavior with bureaucratic approval and rules often binding decision-making [22]. If the state enters into a contract on society's behalf, it moves away from full state production to mirror some elements on the market, not fully competitive but incentivizing behavior for desired outcomes.

11.7.3 Contract Features and Implications for Contractual Management

SHI implementation has certain features that can pose challenges to contract management, particularly by the public sector. Certain contract practices like designing and enforcing performance measures, termination or re-bidding and soliciting bids may not be straightforward options, posing risks to contract management [27].

Firstly, under social health insurance, the public or state element is largely a funder or a funding institution purchasing services on behalf of its members. With members and state funds, it can be a big funding source, posing a monopsonistic (single buyer) element to the market, influencing the prices and availability of services on offer. While PhilHealth accounted for under 20% of total health spending in the country, it is not the only buyer (a user charge system also includes households, along with employers and private insurance companies paying providers directly for health care), but the health financing arm of government. This poses an **imbalance in the power dynamics** between funder and agent and, thus, limits the use of the principal agent model as a useful tool to assess accountability because weak agents may not be able to affect the principal's behavior [19].

Secondly, due to various modalities of membership or entitlement, those who are eligible for services will need to be clearly identified to service providers. If the funder has limited systems (e.g. manual instead of electronic) to track membership, it will make for an **inefficient service administration**, possibly heightening leakages, where those who are entitled are not served or those who are served are not entitled.

Thirdly, **competence** in contract administration is a prerequisite. Service provision will be requiring special expertise, and often not an on-off transaction but a repeat or continuum of service type. In particular, there should be a sufficient number of manual adjudicators for pre-authorizations. This narrows the supply of providers, enabling them to demand a higher price for their services. However, in those cases in which the providers are government agencies themselves (as in the case at hand) or any non-profit organization, service contracts may be sensitive to time, funding and personnel constraints. Changing rules and requirements, often enacted due to populist pressures, affect implementation and program development. At some point, program goals may be obscured or could diverge and, along with contract implementation situations, give rise to **accountability issues** [27]. In social contract language, there is sufficient support from Locke's view of the ethics of accountability, where institutions with the 'right to punish' can be held accountable [12].

11.8 Implementation of the Decision

Not to be considered here.

11.9 Process Optimization

Task 6: Propositions for optimizing Z Benefit contracting.

11.9.1 The Social Contract and the Way Forward

Looking into the 'social' character of the Z Benefit contract, particularly in terms of social justice consideration given that the poor constitute its priority population, the social, bureaucratic and political constraints in contract implementation raise the issue of social consensus. With the selected few providers who entered into a Z Benefit contract, the working group needs to draw up what they have learned from over half a decade of implementation and gain consensus to build a case for participants performing a social contract beyond their usual business interests. Metrics on losses to their business, if the cases served went unreimbursed because these patients were not covered by SHI, can provide economic argument. More importantly, savings to society from improved care quality and patient outcomes will also need to be made. All this requires the **use of data** and highlights the importance of monitoring and evaluation. Issues of compassion and sentiment can certainly be raised, particularly in terms of the population target group. Changing the way SHI pays for providers, for example by using integrated or nationalized services (PhilHealth runs its own facilities), morbidity adjusted risk-based allocations in budgets or capitated allocations, can qualify for, continuing the social contract metaphor, a Rosseau-type of structural transformation. Short of such transformation, PhilHealth and providers like P-MC can institute management reforms to closely adhere to the contract they entered into through Z Benefits. The goals of the scheme to provide financial protection and quality care for sponsored members will need internalization in contract implementation. Going through each management process entailed in the Z Benefit contract can improve implementation.

11.9.2 The CM Model and the Way Forward for Z Benefit Contracting

To continue from passive to selective contracting, PhilHealth and providers like P-MC can look through a CM lens to improve contractual management capacities. This puts emphasis in particular on planning and monitoring, and on knowledge and risk management activities more generally.

11.9.2.1 Planning

The main question for this section is how PhilHealth will implement the Z Benefit program in a way that assists the contracted facilities to deliver the Z Benefit services to its members by clarifying its intention as well as the contractual elements that will manage risks in an efficient and equitable manner.

The CM process step plan understands the contract as flowing and incorporated into the enterprise planning process. Duran et al. identified the health care contracting process as ideally beginning with the assessment of population needs and health sector prioritization [24]. The purchasing strategy is deduced from this plan phase and moves to service identification and targets to be achieved. This will set off the contracting process to identify and select providers. At this stage, knowledge of provider costs and ability to meet contract requirements are drawn upon as a prelude to contract negotiation and agreement (CM process step draft or renewal). The CM process step implement comes next, with monitoring embedded; it is critical here to identify the nature of the information needed and how to use this information.

Lessons from contracting in the European region highlight how having planning targets in place, from volume to financial exposure rather than the contracting per se, yielded more coordinated actions resulting in lower admission and lengths of stay, along with intangible outcomes of managerial and planning skills for both purchasers and providers [25]. The poor linkage of planning to contracts was shown to be due to: (a) insurance companies (purchasers) not involved in the planning process; (b) cost per case contracts and retrospective methods for actual rather than planned volumes, with the tendency for increased utilization; and (c) absence of the requirement of accountability for efficiency gains, with insurers not being held accountable by the government. For the Z Benefit scheme, the reverse is the case, which may augur well for the outcomes. PhilHealth's financial standing and autonomy puts it in a position to plan ahead without the Department of Health, to define its own requirements, with financial support targets identified (e.g. No Balance Billing), and set contracts on a "leave it or take it" basis. Differing **contexts of practice**, for example between metropolis-based providers and provincial providers, and transaction costs of providers outside these centers, are not made explicit or matched by realistic timeframes specified in the contract. PhilHealth's Z Benefit administrators may use the pre-authorization stage or claims processing to 'buy for time' in order to get the resources and thus create delays. In cases like this, rather than leaving things in limbo, it is best for providers to include some interest rate charges in the contract. Alternatively, PhilHealth can announce its overall budget for Z Benefits, with some regional allocation, to ensure that not all the funds will be concentrated to a few conditions that larger institutions may get the bulk of reimbursements at the expense of smaller institutions in the region. This will require some advance planning and modeling, requiring the use of data and information generated by the implementation of the program for nearly half a decade.

11.9.2.2 Monitoring, Evaluation, and Knowledge Management

The Z Benefit contract needs to specify the indicators that will be used for **performance assessment** and embed a review process that assists providers' review protocols, identify good practice and gaps, and strengthen the evidence of goal achievement. Annex I of the latest circular, as referred to in the Z Benefit contract, specifies a review process that is highly geared towards PhilHealth needs and is not specific with regard the provider's responsibility for reviewing internal improvements. The **duration of the contract**

is currently one year, which may be too short given that, for some Z Benefit cases, treatment may extend beyond one year. Two years may provide the system with some flexibility and sufficient time to assess patient outcomes and behavioral adjustments to provider systems. The P-MC case highlights the lack of adequate grievance systems, given the high-handed policies from the funder. **Risk-mediating sanctions** may be incorporated in the pre-authorization stage in cases of delays, which worsen the patient's conditions, and in the claims processing when filed claims have not been acted upon beyond 30 days. Valid methods of communication can be specified such that, in the absence of actual documents being transferred between offices, an electronic photo-scan will be considered and SMS will suffice for approval subject to its proper recording or screen-capture. Field operations should include a budget allowance for this.

No extensive contracting can be made without a **Performance Assessment System**. The further development and optimization of the Z Benefit program will require an assessment of the program, based on such a system identified in the contract. The facilities and PhilHealth representatives are supposed to agree on indicators, like a dashboard system, by which they can measure performance beyond the number of patients along with some efficiency and equity measures. Progress on the latter point and, given the conditions of failure as exemplified by the P-MC case, a re-framing of the Z Benefit contract into a social contract—one that moves away from the simple principal-agent view which dominates transactions between patient (as represented by the funder) and provider- are called for. The use of 'sin' tax allocations for coverage of officially recognized indigent families, which is the target of Z Benefits No Balance Billing feature, broadens the 'social' aspect towards universality.

No Performance Assessment System will be complete without the coding of cases, which yield insights into provider behavior. Providers are getting used to a coding system for most conditions (introduced in 2010) and much improvement in PhilHealth's relationship with providers has been noted. A **Z-coding** system also needs to be in place in order to incorporate some of the patient information that can relate to outcomes as well treatment processes that are critical to costs and outcomes. Coding will also facilitate reimbursements and minimize face-to-face transactions, saving on travel and other costs, including time.

An **evaluation** commissioned by the Fund could only do a sample study without reaching its target sample size as a substantial number of patients were lost to follow-up, and no routine information was analyzed to complete an evaluation. Patient satisfaction with Z Benefit was reported as high. Performance evaluation is possibly as important as the contract itself.

11.9.2.3 Risk Management

The Z Benefit contract expects to provide greater certainty to quality of care by ensuring the diagnostic stage and treatment protocol are specified. The highly specific treatment protocols were drawn up with the relevant medical societies using updated guidelines based on evidence and current standard practice. Any space or item not undertaken in

the ticked-off form will lead to rejected claims without any explanation. But only experienced specialists may take time to follow new guidelines. Usually professionals want to keep doing what for them would be a tried-and-tested procedure that yielded positive outcomes from their experience. Z Benefit seeks to influence towards multidisciplinarity, which may not yet be embedded in hospital culture, as per evidence that a team approach improves patient outcomes. Manual audits or medical reviews are made by PhilHealth, and with **voluminous paperwork**, there is no assurance of efficient decisions. Limited PhilHealth staff, both in numbers and capacities, **heightens the risk**. Expertise in contract management, monitoring and negotiations, communication of expectations as well as technical information are needed. A general assessment of PhilHealth highlighted shortcomings in actuarial, health technology assessment, informatics and business analytics [8]. The quality of health care services aspired for by the Funder can be viewed in terms of the organization's commitment to the quality of its contract management.

11.10 Actual Execution

As a single purchaser with a 17–19% share of total health expenditures in the country, PhilHealth has not optimized its ability to influence provider behavior in terms of quality, pricing and organization of care. Congress has recently passed the new Health Security Law that calls for wider adoption of contracting to cover not only Z Benefits type of health conditions, but to start from prevention to hospitalization. A gatekeeping system will be put in place and service identification will be operating from a negative list. PhilHealth's latest financial statement (for the year 2017) showed the organization in the red, spending more than its income, the first time possibly in its existence. Its credibility in contract commitment is dented.

11.11 Learning Outcome

11.11.1 CM Value for the Case Study

From a learning perspective, the PhilHealth Case highlights the usefulness of the CM Model in viewing contracts and in extending it to management functions that include the institutions' ability to design and invest in the needed systems and processes to handle inherent transaction risks as well as external health system risks. Without these investments, health care contracts are no more than legal instruments to justify government outlays for the Funder and the receipt of funds for the contracted government facilities.

While the CM Model was developed with the business sector or with general transactions in mind, this exploration on government contracts through the CM lens highlights the importance of key tasks like knowledge management, particularly in terms of the information flows, and the transformation of information drawn from

implementation into knowledge or useful lessons. When looking at the **management tasks required to improve implementation**, particularly in terms of risks related to funding positions, the CM view flowed smoothly to social contracting. The possibility of a social contract built into the contract itself through proper planning and monitoring, in particular, can improve accountability in terms of performance targets, realism of timing and assessments of risks, and responsiveness to the conditions affecting intended population groups. For government to government contracts, often with its mechanistic implementation, the CM Model provides tools for process optimization, particularly risk and knowledge management. The analyses emphasized that communication management is essential to maintain contract integrity as well the timely transfer of information to improve implementation. Any discussions of future contracting, with wider remit than just selected cases and networked providers, need to learn from the implementation of the Z-Package. The CM Model is handy as it can accommodate both need-based and efficiency-oriented program settings and casts a pragmatic approach to contracting at enterprise or societal levels.

11.11.2 Case Study Value for the Reader

Health care financing and delivery present challenges for every society. It is associated in particular with the global need to control for health care costs as well as with the assurance of people's right to healthcare services. Health care is one area in which the stakes are high and many players or actors have different pieces of information and hold power differently on this basis. Costs are high if contracts are individualized between each patient and provider, and each provider and funder. For social justice considerations, for quality of care, and for efficiency, the wider perspective of social contracts is warranted. In light of the fact that with the type of contract considered in health insurance and with the universal health coverage thrust, the obligations and responsibilities for safeguarding funds for future benefits and for social justice considerations must be embedded in the contract through **attention to processes that enhance contract fulfillment**. The purchaser must not be only concerned with control of provider; neither should providers be seen as being primarily concerned with payments. The challenge is in moving contract motivation beyond incentives or even political pressures or behest towards being the 'right' thing to do as it leads to desired health, social and financial protection outcomes. To achieve this is to view contracts as the impetus for instituting better management, not only for the contracts, but for the institutions and the health system as well.

What appeared as 'contract failure' in our case reflected the limited **contractual management capacities** of the implementers. The services dealt with are complex and the delays and inefficient implementation cited arose from the limitations of state institutions in implementing its social contract. The CM view highlighted how knowledge management can be used to improve the program, particularly in planning and monitoring, to facilitate contract renewal or termination. Thus, the importance of information and its

use cannot be overstated. The same is true for risk management: contract risks abound across transaction stages, from member eligibility, pre-authorization through to claims processing and reimbursements.

While the case highlighted provider contracts, applying the CM frame brought the analysis to 'social contract', with the actions of government institutions under scrutiny in terms of the underlying social contract with the people. The transformation of the Z-Benefit from a transaction contract to a social contract in the analysis entails understanding the processes by which various stakeholders lay claim on the social health insurance funds based on the overall attainment and **consensus on social justice** for the poorer members of society, as well as quality of care. This consensus is not instantaneous and widespread; it needs to be continually grown and shared, akin to 'learning by doing', through participatory and collaborative contracting. The social contract entails safeguarding the pooled funds from personalistic, social, bureaucratic and political constraints, and thus requires more deliberate and detailed attention to the management of institutional contracts and its accountability.

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The Jamaica Coalition Case—Managing Political Coalitions Through Contract

12

Antonio Giarra-Zimmermann and Bert Eichhorn

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A. Giarra-Zimmermann (✉)
Landesvertretung Rheinland-Pfalz, Berlin, Deutschland
e-mail: agiarraz@t-online.de

B. Eichhorn
SRH Hochschule Berlin, Berlin, Deutschland
e-mail: bert.eichhorn@srh.de

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Abstract

This case study focuses on the application of the CM Model to a political negotiation and, specifically, to exploratory talks and a coalition negotiation. The case study demonstrates that, even in this context, the model delivers substantial results. It examines the attempted Jamaica coalition negotiations at the national level after the federal election in Germany on September 24, 2017. The case study highlights the complexity of such negotiations in particular during the exploratory talks but also reveals the particularities of political management, showing both similarities and differences compared with business negotiations. At the same time, it illustrates the circumstances under which the exploratory talks could have ultimately been successful, leading into a coalition negotiation, and it demonstrates which preconditions would have been necessary to ensure such a successful conclusion.

Keywords	Exploratory talks, coalition negotiations, political management, legal obligation in politics, political agreements, foundation of trust
Principle management topic	Contracts in social context
Institution	Political parties
Subject of management	Relationship (political coalition), 'enterprise' (political parties)
CM process step	Plan, draft
Management field	Risk management, corporate management, management of relationship, knowledge management
Contract type	Political 'contract'

Editor's Note: For a full understanding of the CM Model's practical benefit for the case study, the reader may have to peruse at least sect. 1.4.4 and 1.4.5 of Part I. The keywords used above to characterize the area of contract application are explained in the key system preceding the case studies in Part II.

12.1 Challenge

12.1.1 Set of Facts

In the federal election in Germany on September 24, 2017, none of the political parties could win a majority but several different options for forming a coalition and a new national government seemed possible.

Explanation: Coalitions und Coalition Agreements in German Politics
"A coalition (from the Latin *coalitio*: coming together, merger, unification) is a temporary alliance between political parties (in a representative democracy)"[1] [1]. The most important foundation for a coalition is the coalition agreement: The medium- or long-term cooperation of a coalition government during a specific legislative period is organized by a coalition agreement between two or more political parties with the intention of forming a governing coalition. This agreement outlines an overview of the planned legislation of the coalition-supported government. There are no prescribed legal procedures for forming a coalition agreement in Germany; therefore, the political parties are completely free in its formulation.

The first option attempted was the Jamaica coalition, that is, a coalition made up of the colors of the Jamaican flag corresponding to the classic color assignment in the political spectrum[2]: the Union Parties CDU/CSU (black), the Liberals FDP (yellow), and the Green Party (green).

Following the federal elections on September 24, 2017, the CDU/CSU, FDP, and Green Party decided to hold **exploratory talks** about the possible formation of a coalition which officially began on October 18, 2017.

Explanation: Exploratory Talks in German Politics
Before the begin of the coalition negotiations during which a formal coalition agreement is formulated, there is often a preliminary need to discuss options by way of exploratory talks/negotiations. This provides all parties the chance to carefully consider whether they will be able to realize their own programmatic goals and ideologies within the larger structure of the proposed coalition before actually beginning negotiations for a coalition agreement.

[1]Own translation.

[2]CDU (Christian Democratic Union), CSU (Christian Social Union), FDP (Free Democratic Party), Bündnis 90/Die Grünen (Alliance 90/The Greens).

From the outset, these exploratory talks were characterized by the fact that each party wanted to make its own points of view known publicly. Thus, the public was given the impression that, although intense negotiations were taking place, the parties did not have the trust and confidence in each other that was required to present the public a common version of their progress. After a long and arduous period of negotiations—highly unusual at the level of federal government in Germany –, the key political actors Angela Merkel (CDU), Horst Seehofer (CSU), Christian Lindner (FDP), Cem Özdemir and Katrin Göring-Eckart (the Green Party) gave an official date of November 19, 2017, at which time they would announce whether their exploratory talks had been successful and whether they would lead into a coalition negotiation or not.

A **quick analysis of the positions** of the parties involved in the Jamaica exploratory talks on the basis of their party platforms (see on fdp.de; csu.de; cdu.de; gruene.de) reveals the following key points with regard to their respective political interests:

The **CDU/CSU** must uphold its core values of 'internal security' by way of a restrictive immigration policy and a liberal economic policy which refuses to take on (new) debt and avoids tax increases [2, 3].

The **FDP** wants to emphasize its goal of a liberal tax policy by dismantling the solidarity tax in order to lessen the overall tax burden on individual citizens. It also promotes a modernization of the state through an improved education policy and liberal immigration laws [4].

The Greens intend to promote their values through practical measures in climate change policy, including shutting down coal energy, as well as through a defense of the liberal immigration policy in recent years by emphasizing family reunification laws [5].

Each political party must make a careful assessment of whether or not to take on the risks of joining the potential coalition. This is seen, in particular, in the final search for a compromise when all of the various political issues must be examined according to a cost/benefit analysis in order to build a solid foundation for making the best decision. Shortly before the end of the exploratory talks in the middle of November, 2017, it was determined that there are 125 unresolved issues [6] and 90 open conflicts [7] remaining among the negotiators.

In the final days of the Jamaica exploratory talks, an overview of the current status of the negotiations has been produced (unpublished, informal manuscript from November 15, 2017: "Results of the Exploratory Talks between the CDU/CSU, the FDP and the Green Party"). This document has revealed the progress that has been made during the talks while simultaneously highlighting the many conflicts which remained unresolved.

A steering committee was appointed for the Jamaica exploratory talks and it was tasked with, among other things, the job of organizing a timetable and a document recording starting positions, attempted and reached consensus. Thus, throughout the negotiations, they continually produced a running table of points of dissent and consensus. The members of the steering committee always included the Secretary Generals of each party, but in this case the head of the parliamentary party in the German

government and chancellery made an appearance as well. The steering committee of the Jamaica negotiators included Peter Tauber (CDU), Alexander Scheuer (CSU), Marco Buschmann (FDP) und Michael Kellner (Greens), as well as Peter Altmaier (Director of the Chancellor's Office and Finance Minister), Michael Grosse-Brömer (CDU) and Britta Haßelmann (Greens), both parliamentary heads of their factions.

On November 19, 2017, the **status of the negotiations** is the following (based on the document from November 15, 2017):

- The most important negotiating success for **the CDU/CSU** is the feasibility of an immigration limit of 200,000 refugees per year (with exceptions for family reunification) and the future legislation project of a skilled labor immigration act. At the same time, they are able to defend a key issue which is a core value of the party and had contributed to their success in the federal elections: the zero new debt policy is practically set during the negotiations.
- The primary goals of **the FDP** are within arm's reach: the abolition of the solidarity tax and thus decreasing tax burdens on individual citizens as well as the modernization of the state through improvements in education including **getting rid of the ban on cooperation in the education system** (giving the federal government a greater influence on higher education policies, which were originally determined by the individual states in Germany) and a liberal immigration policy all seem to be attainable through further negotiations.
- **The Greens** have also success negotiating their most important political issues: climate protection and adherence to the climate protection goals 2020 to 2030 as well as a concrete plan for the reduction of CO_2 emissions by shutting down coal-fired power plants and expanding the development of renewable energy sources.

However, all three parties expect painful compromises and must calculate their own risk analysis for possible future election victories:

- **The Union Parties** have to factor into their balance sheet the economic burden which the climate protection goals and agricultural policy (end of glyphosate) will cause.
- **The Liberals** find the financial political goals (complete elimination of the solidarity tax within the legislative period) and the proposed changes in the education policy (abolition of the cooperation ban and the increasing influence of the federal state on the education policy) to be insufficiently ambitious.
- **The Greens** no doubt find the movement away from a liberal immigration policy and the acknowledgement of a future limit of 200,000 immigrants per year very painful and must weigh this into their risk analysis.

A detailed process examining each topic of the exploratory talks paper (the results of the exploratory talks) was to begin immediately following the decision of the three (four) coalition partners CDU/CSU, FDP, and Green Party to continue on to official coalition

negotiations. The steering committee would, however, first need to agree on a timetable and assign negotiators to specific working groups. In addition, each party would need to choose one representative for the respective negotiating groups. Transitioning from the exploratory talks to the coalition negotiations, the discussions would become more detailed and begin to outline a government program for the coming four-year legislative period.

The political agreements laid out in the exploratory talks paper would serve as both a target range and framework for the coalition negotiations. Fundamentally new proposals that were not discussed during the exploratory talks would only be possible in exceptional cases, for example, if a problem had been overlooked and an amicable resolution is suggested and mutually agreed upon. The implementation of the political arrangement outlined in the coalition agreement would ultimately become the legislative tasks of the public administration of the federal government. The steering committee would give technical and legal advice to the key negotiators throughout the entire negotiating process and have considerable influence over the concrete design of the projects. Political compromises would generally need to be made within the existing legal framework and taking juridical considerations into account. However, the resulting coalition agreement is not a legally binding document but simply a political agreement.

Contract Knowledge: The Lack of Legal Obligation in Coalition Agreements
Coalition agreements are not legally binding [8]. They are considered "political agreements" and nothing more: "Coalition negotiations and coalition agreements belong to an informal phase of government formation which is not regulated under constitutional law. Parties can do what they want here as long as they stay within the bounds of the constitutional democracy and political principles of their own party" ([9], p. 865). "The coalition agreement is not a 'contract' in the legal sense of the word but a political agreement. For the party members involved, it is therefore only politically binding but never legally. The contract does not represent an imperative mandate through the backdoor either" ([9], p. 865).[3]

By November 19, 2017, the ongoing exploratory talks reach the point of resembling a suspense novel: The chief negotiators from each party gather repeatedly and their meetings take place in various formats. On November 16, the FDP had already put a time stamp on the entire negotiating process: the final decision is to be made by 6 pm on Sunday, November 19. The possibility of an extension has also been written off: "6 pm is the deadline for us" [10]. But at 5:59 pm on November 19, it seems the clock has stopped: Late in the evening, the FDP finally announces: "Nothing new, there is no consensus in sight. After extensive discussions among the chief negotiators, the individual parties will now gather for internal discussions…" [10].

[3]Own translation.

Thus, before the FDP decides how to present their decision of successful or failed exploratory talks—both internally to the negotiating committee and to the public—they are once again fundamentally re-examining what the best decision within the framework of the FDP's political management would be. This means the party chairman Lindner is deliberating for the final time whether he should let the exploratory talks fail or carry them on to a possibly successful conclusion, thus allowing for the start of official coalition negotiations.

12.1.2 Operating Procedure

12.1.2.1 Author's Explanations

The case study revolves around the question whether the chief negotiator of the FDP should continue the exploratory talks or not. Implicitly, this question raises another issue: Can the CM Model help deal with this question in a systematic way?

Thus, it first needs to be examined whether the CM Model can be applied to the political management of coalitions. Two characteristic features have already been identified: the binary division of the negotiation process into exploratory talks and official coalition negotiations as well as the fact that the coalition agreements are not legally binding. Neither of these features has a direct equivalent in business management. Thus, we must examine more closely the fundamental differences between political and business management and consider how these differences will affect the applicability of the CM Model on to cases of political management.

Next, it must be determined how useful the CM Model is for the negotiations of political agreements. This involves the CM process steps plan and draft since the coalition negotiations build upon the results of the exploratory talks. The exploratory talks paper makes up a significant part of the draft for the coalition agreement since it records the various interests of each party. It outlines the key points of the coalition negotiations (process step plan) and often already puts many of the details down in written form (process step draft).

From the point of view of the political party FDP ('enterprise' according to the CM Model), the case study is about a cooperation with other parties ('relationship' in the CM Model)—in this case, the CDU/CSU and the Green Party. At the moment of decision-making, there are also possible 'transactions' (i.e. the implementation of political projects into legislation and government policy as laid out in the framework of the exploratory talks paper) which are concretely discernible and must be taken into consideration as necessary.

For this case study, it is important to look carefully at the party platforms and the political context, insofar as these are already required by the CM process steps plan and draft and can be extracted from the set of facts of this case study. The inclusion of the various 'projects' discussed in the exploratory talks is also necessary because of the

issues described in the negotiation outcome and their potential influence on the credibility of the FDP.

The particularities of political management already mentioned (binary division of the negotiation process into exploratory talks and coalition agreement, lack of legal obligation of the coalition agreement) as well as the particularities of the structure of the exploratory talks and the actual negotiation process itself all bring up the question whether and in what form the political management of the exploratory talks can be understood through the management fields of the CM Model. It quickly becomes apparent that the analytical focus of these management fields lies on risk management and corporate management. Due to the lack of publicly available information regarding the internal party discussions and the external communication process among the negotiating parties ('business cooperation'), knowledge management comes into consideration first and foremost as lessons learned ('process optimization') insofar as enough information can be gleaned from the official reports.

12.1.2.2 Reader's Tasks

The reader is invited to consider two issues each of which breaks down into different questions and tasks.

The first issue involves the applicability of the CM Model to the political management case at hand. Three questions must be answered:

Question 1: Can the exploratory talks for a coalition be compared with a situation in the business world?
Question 2: What effects do the differences between political and business management have on the applicability of the CM Model?
Question 3: Do the management fields of the CM Model correspond with those in politics?

The second issue relates to the political decisions to be taken. Take on the role on the advisor to the chief negotiator of the FDP, Lindner, and consider three relevant tasks:

Task 1: Make a last-minute proposal for a decision for the evening of November 19, 2017 and give suggestions for the course of action to be taken. (Level of difficulty: High).
Task 2: Give concrete suggestions regarding how the FDP party leader should implement this decision proposal. (Level of difficulty: Medium).
Task 3: Offer the party leaders ideas for how to optimize their conduct in future exploratory talks and coalition negotiations. (Level of difficulty: Medium).

12.2 Decision-Making Process

12.2.1 Evaluation of the Decision-Making Circumstances

12.2.1.1 The Features of Exploratory Talks

Question 1: Can the exploratory talks for a coalition be compared with a situation in the business world?
The present case deals with the initiation of a political coalition, i.e. a mid-term cooperation between two or more independent institutions. This situation has clear parallels to the initiation of a joint business venture.

Contract Knowledge: Joint Venture
A joint venture is defined as a mutual enterprise between two or more legally and financially independent companies, in which both partners carry the managerial responsibility and financial risks together. The key element of a joint venture is a mutual interest in creating a joint venture contract, which regulates the division of profits and shared control. The joint venture contract should provide a detailed roadmap of their business dealings and outlines their mutual interests and goals as well as the legal/business relationship of the involved parties.

For **further reading** on joint venture, see [11].

The criteria named in the explanation box above correspond well to the exploratory talks and coalition negotiation: The mutual interests of two or more independent parties are carved out during the exploratory talks and expressed concretely in a cooperative government program. The mutual control occurs with structural measures for reassessment in place: for example, the office of the chancellor and the responsible party officials continuously monitor each party's conduct according to predetermined guidelines and goals. In this political context, the division of profits corresponds to the future electability of the coalition partners. Finally, an agreement regarding a common code of conduct also exists within the exploratory talks and coalition contract. However, the coalition contract—in contrast to the joint venture contract—is not legally binding.

The coalition agreement can be compared with a '**contractual joint venture**' insofar as the partners don't found a single, common legal entity, but instead continue to outwardly act as independent partners.

Contract Knowledge: Contractual Joint Venture
No new legal entity is founded with a 'contractual joint venture.' Two or more companies work together on a purely contractual level. The contract regulates their mutual business activities, but the companies outwardly continue to represent themselves.

Regarding the term contractual joint venture, see [12].

The division of labor as seen in the exploratory talks and coalition negotiation is also nothing new in the business world—albeit appearing in a different form. Contract negotiations often include breaks, for example in order to obtain approval for certain negotiation outcomes divide the negotiations into different phases. In this case, a **memorandum of understanding (MoU)** or a **letter of intent (LoI)** may be generally produced, which puts the negotiation outcome into writing.

Contract Knowledge: Memorandum of Understanding and Letter of Intent
"A **memorandum of understanding (MoU)** is a type of agreement between two (bilateral) or more (multilateral) parties. It expresses a convergence of will between the parties, indicating an intended common line of action. It is often used either in cases where parties do not imply a legal commitment or in situations where the parties cannot create a legally enforceable agreement. It is a more formal alternative to a gentlemen's agreement." [13].

A **letter of intent (LoI)** likewise articulates an intended common line of action with the same guidelines as in an MoU. In practice, these terms are often used interchangeably. For more information on the term MoU, see [14].

However, while MoU and LoI are legal contracts, they are in general not legally binding according to their rational logic and wording, i.e. they are not legally enforceable.

Due to the lack of a **legally binding** nature in coalition agreements, this shifts the meaning of the contract negotiations towards building **stable relationships of trust** among the partners ('enterprises'). There is a strong parallel here to business contracts. Although business contracts are in fact legally binding, legal enforceability is rarely the goal in the area B2B. The advantage rests solely in the **potential** threat of legal enforcement of claims, which does not exist in the developmental phase of coalitions in political management. Thus, in business as in political management, the focus is on creating a relationship of mutual trust between the negotiating partners. This is illustrated by the concept of an incomplete contract (from economic contract theory), which stresses the inevitably regulatory gaps in business contracts and, thus, the probability of disagreement—no matter how well it has been prepared.

> "In the language of economic contract theory, coalition agreements are therefore typical examples of incomplete contracts, in which the partners can't agree on explicit rules for every future situation and the resulting rights and duties of each partner. For this reason, these contracts often contain procedural rules for working through future disagreements that are currently unforeseeable or can't be dealt with at the time of negotiations." [15, 16][4]

As in business, disagreements in political negotiations can ultimately only be bridged by trust in the procedural rules which regulate fair solutions for future (political) conflicts.

Thus, in both fields, the primary function of the contract is not its judicial enforceability, but rather the trust-building nature of an agreement and its governing effect as well as an indirect, social sanctioning through loss of reputation (in business) or loss of credibility in the public perception of the affected party.

12.2.1.2 The Differences Between Management in Politics and in Business

Question 2: What effects do the differences between political and business management have on the applicability of the CM Model?
To answer this question, we will consider political management, see whether there is a coalition negotiation best practice, and finally tentatively try a comparison.

12.2.1.2.1 Political Management

In the field of politics, systematic approaches to the (general) management of political processes are not discernible. There are **no clearly defined, universally valid processes** of quality management that are governed by a continuous optimization as there are in businesses.

Explanation: Political Management
Upon closer examination, political management turns out to be an indeterminate term that can encompass different meanings and opens up even broader research fields in its practical implementation. It is often defined in relation to other issues, for example a strategy for political management or for coping with a crisis situation, and often in connection with communication problems or in relation to governmental actions. The procedural character of the term is justifiably emphasized with regard to changes in certain developments, for example the implementation of certain political goals in parliament.

Typical keywords of political management include: political planning, efficient organization, leading or exercising power (= power management, e.g. persuasion and majority management) and the management of political parties or a political process (including, for example, a political election) or a government (and also an

[4]Own translation.

opposition) with regard to the implementation of political goals; leading or coordinating the participants involved in a political process or party, or a public administration; control over the results of a political process or executive (government) and legislative (parliament) function; making use of human resources [17–20].

Consequently, there are also differing definitions of the term political management:

- Very generally: "Political management is about managing resources available to achieve your goals" [18].
- More concretely: "Political management involves planning, organising, Human Resources, leading and reviewing resources including people (politicians, staff, advisors and volunteers), organisational structure and funds (budget, donations) to achieve a range of political and public goals effectively" [18].
- In more practical terms: "Political management means guaranteeing the essential functions of the government—leadership, decision-making, coordination and organization—in the face of complex problems and through the development of new, more efficient problem-solving strategies […] Political management refers to all three dimensions of the political—polity, politics, and policy."
- And with regard to the logic of action: "Political management means pragmatic action and follows a political rationality. The logic of action of political rationality is geared towards the goal of power acquisition" [19].[5]

In attempting to define the term, there are also many references to similar objectives in business management: 'the art of getting things done through people' or a "highly expansive, multidisciplinary field that seeks to theorise and explain how best to achieve the objectives of a given organisation efficiently and effectively through planning, organising, leading, and controlling the organisation's resources" [21].

It therefore must be examined if, at least in the aspect of political management discussed here—that is, the political management of coalitions—a clear concept of the term and definite procedural structures in the form of best practice have emerged which justify the application of the CM Model.

12.2.1.2.2 Best Practice of Coalition Contracts?

The framework of political management of coalitions is only specified by German Basic Law and party law. However, the development of the coalition agreement since the 50 s and 60 s reveals a consolidation of content and especially an increasingly concrete ascertainment of projects to be implemented.

[5]Own translation.

Explanation: The History of Coalition Agreements in Germany[6] since the 50 s and 60 s

In the 50 s, there were so-called "exchanges of correspondence"– also called coalition arrangements—which dealt with content-political and structural questions of government organization, but which were not published in connection with government formation. (For more information on the history of coalition agreements especially involving the CDU/CSU: http://www.kas.de/wf/de/71.9390/). 1961 was the first year that the entire coalition agreement—still referred to as a deal—was published in the newspaper Die Welt. Nine pages in total, the coalition agreement was extremely concise and simply contained the common goals of the CDU/CSU and the FDP written in shorthand as well as the unpublished coalition agreement from 1957 (from the documents of CDU politician Hans-Joachim Merkatz). In 1966—with the start of the first grand coalition in Germany between the CDU/CSU and the SPD—there was no formal coalition agreement but only "the SPD's guiding principles for the coalition negotiation in the autumn of 1966" which was made available to the press and influenced Chancellor Kiesinger's governmental declaration. This method of necessary arrangements was continued in 1969 with the social liberal era: while there was still no formal coalition agreement, they did create a so-called "coalition paper" (unpublished) which primarily consisted of a proposed division of labor between the SPD and FDP. In 1982/1983, the period of a conservative liberal coalition, there was also no coalition agreement published. Finally, in 1998 with the red-green coalition, a 42-page coalition agreement was published delineating arrangements in all political areas as well as the intended division of labor [17]. This has continued on as the standard even today. In 2002, the agreed upon arrangements were set forth in an expansive and detailed 90-page document. In 2005, the coalition agreement between the CDU, CSU and SPD reached 143 pages—191 pages including the appendix of preliminary results of the coalition working group for federalism reform. The renewed coalition between the CDU/CSU and the FDP in 2009 as well as the second grand coalition of 2013 steadfastly adhered to a detailed agreement covering all political issues and staff assignments. However, the 2009 agreement received more than 90 commissioned audits and this was likely a reason for the subsequent lack of solidarity among the coalition partners. "Thus, the negotiated coalition agreement contained […] stumbling blocks: […] there were meetings regarding the concrete design of various issues during the legislative period, but for key decisions, they only found 'dilatory, superficial compromises'."[7] The following coalition agreement by the grand coalition of 2013 'only' had 60 audits.

[6]Until 1990, only in the Federal Republic of Germany (West Germany).

[7]Own translation, original wording: „*Der ausgehandelte Koalitionsvertrag enthielt somit… Stolpersteine:… wurde die konkrete Ausgestaltung vieler Punkte in die Legislaturperiode vertagt; zu wichtigen Schlüsselentscheidungen finden sich nur ‚dilatorische Formelkompromisse'.*" [34, 35].

Thus, we can assume that there is a kind of "political process optimization" taking place in this field which may culminate in a political coalition best practice.

12.2.1.2.3 Differences and Similarities

The division of the negotiation process into exploratory talks and coalition negotiations as well as the lack of legal enforceability of coalition agreements represent clear differences between political and business management. In addition, the entire political management of coalitions experiences constant media coverage and the party members especially aware of this as they are reliant upon the continued support of their party base after the successful end of the negotiations. Other specific features named under Sect. 12.1.2.1 pertain to the internal processes of the organization of the exploratory talks and negotiations within the individual party ('enterprise'). For the external processes of 'business cooperation,' the particular features of the conduct of negotiations (content-related and organizational) as well as the implications of the lack of a legally binding agreement must be taken into account. Finally, we have to check to what extent the principles of a fair negotiation as practiced today according to the field of business management can be applied to political management, for example the Harvard Method.

At this point, the above-named differences between political and business management need to be explored in more detail: As already mentioned, it must take into consideration that with political management the entire process is under **constant public observation**, including regular public opinion polls. The current status of the negotiation is continuously communicated to the public, resulting in discussions and evaluations, which in turn influence the negotiating possibilities of each party. The development of the negotiation is followed by the public with great interest. The consequence of this is that the negotiating partners always have an eye on the political risks and pay a lot of attention to their perceived credibility as a political party ('enterprise'). The division of the negotiating process into two parts lends a certain amount of negotiating room in relation to the expectations of media coverage: the exploratory talks only reach the CM process step draft and so there are no final, concrete political obligations at this stage. In this way, each party can receive initial feedback both from the media coverage and from their own party base before any final political decisions are made. This can, in turn, positively influence their negotiating power. However, it must also be taken into account that the party base can have a big influence on the outcome as well; in some cases, the party base is asked at the end of the negotiations for its consent regarding the decisions made by the coalition negotiators (this could easily be the case for the Greens here).

This circumstance (constant public observation) is also evident in the **organization of the exploratory talks**. Negotiating teams are formed at all levels during both the coalition negotiation and exploratory talks: steering committee, coordinating group, work group, etc., whereby the political ranking within the parties must be taken into account and in some cases the enlistment of regional representatives and an internal arithmetic, for example, political wings, gender equality in assignments and overall, regional proportions, etc., must be considered as well.

The party leaders generally also take on the leadership of the coalition negotiations. In the case of the Jamaica negotiations in the fall of 2017, Merkel (CDU), Seehofer (CSU), Lindner (FDP) and Wolfgang Kubicki, as well as two party members from the Greens Özdemir and Göring-Eckardt. For the overall management, the party heads, faction heads and general secretaries are chosen. In addition, the respective party representatives and to some extent the representative members of the factions in the German parliament also take on management roles.

The division of the negotiation process also directly influences the management fields of the negotiation and this expresses itself within project management. Because of the complexities of political management mentioned above, a special internal project management is required for carrying out the negotiations within the party ('enterprise'). On the other hand, it must be taken into account from the beginning to what extent the projects of the future political cooperation (implementation of legislative and executive plans) will correspond with the successful implementation of the party's own platform (corporate management) after the conclusion of the negotiations. The question of the credibility of the party ('enterprise') in relation to project implementation must be continuously checked during **the development of the negotiations**. This becomes clear with regard to content-related and organizational aspects of **negotiation management**, which in particular in the area of financial possibilities are strongly linked to the promises of the party platforms (corporate management).

As already mentioned, the primary risk of a party engaged in exploratory talks (risk management) consists of deviating too far from the standards of the party platform and the resolutions of the party (corporate management), which would jeopardize the party's credibility in the eyes of its voters and thus its future electability. Furthermore, with every political issue at hand, the negotiator is also tasked with weighing the financial risks of an overall compromise (see also the comments from: [22] and from organizational view point: [7])

During the plan and draft phase, the political viability of the outcomes of the exploratory talks (within the framework of risk and corporate management) provides an indication for its compatibility with the party platform and thus an integral component of a first plausibility check (just as the steering committee carried out during the Jamaica coalition exploratory talks). The plausibility check takes place with an eye on the compatibility of the exploratory talks with the political restructuring of the parties (i.e. the basic manifesto and election platform) and the differing expectations of interest groups, all of which need to be reconciled in order not to risk the party's credibility before even beginning the political implementation of a governing coalition.

The organizational features of the exploratory talks mentioned above make it clear that a significant amount of knowledge management (and corporate management as well) is required at different levels in order to be able to check the plausibility of the negotiation outcomes with an eye towards a possible coalition agreement. Thus, the CM process steps plan and draft conceptually also cross over to the step implement.

Finally, along with the particular features of political negotiation and the organizational aspects of **negotiation management**, it must also be examined whether the differences between politics and business impact the principles of negotiation management themselves.

Negotiations in business management should not exhaust themselves with 'haggling over positions' or 'hard or soft negotiating.' Rather, the focus is on creating a win-win situation (integrative problem solving), i.e. an optimal solution for all negotiating partners through the founding or maintaining of good, long-term partnerships and an efficient negotiation management for example on the basis of the Harvard Method (see [23], which has also been empirically checked and recognized as useful in the field of political management).

In political management, this could of course be hindered by the fact that the parties bring varying degrees of negotiating power to the table depending on the election results. Furthermore, the parties might be under pressures from their own supporter base which can directly influence the negotiations, possibly leading up to the threat of a party-internal referendum opposing the results of the coalition negotiations (**majority management and persuasion management**). In terms of power politics, the political disadvantage of one party can at times lead to a distinct advantage for another party with the consequence that this party is seen overall as more successful in terms of the interests of the country and the electorate, which in turn increases the public's trust in the party as well as the party's potential for re-electability (**power management,** see [24]). Such zero-sum games, however, can be equally observed in business.

Comparable situations can also be found in business albeit with slight differences. Depending on the size of the company, the shareholder structure, and the national legal framework, there is also competition for majority support in bodies such as the executive board, supervisory board, etc. At the level of real decision-making (normative level, for example majority shareholder), business companies can often make organizational changes faster and with more flexibility than in politics and can easily implement top-down approaches.

With political management, the primary goal (short and long-term) has to be power acquisition in order to be able to exercise agenda-setting power. In business, the power lies first and foremost in economic strength in competition. Economic negotiating power exists to varying degrees depending on the size of the business, and companies often try to outsmart their negotiating partners in order to gain an economic advantage. Of course, there is not the same level of public awareness of the negotiation as in political management, but the effects of economic power are ultimately also 'publicly controlled' through consumer protection, NGOs and internal guidelines, for example in the area of corporate social responsibility. The public reputation of a business is much more important today than a slight economic advantage over another partner.

As a result, there are still considerable differences between management in politics and management in business, which makes a direct application of the CM Model appear

questionable. Best practice tends to speak for comparison. A further point of departure for the CM Model could be the model's management fields if they are found to be comparable to the management fields in politics.

12.2.1.3 The CM Model's Management Fields in Politics

Question 3: Do the management fields of the CM Model correspond with those in politics?
During political disagreements between the parties, the obligations of the coalition agreement is continually brought up so that—just as in business management—the binding force of the coalition agreement in political management is created in practice through accountability.

At first glance, the four management fields of the CM Model don't correspond one to one with the areas of political management in the overall applicable form of process operations. We must therefore perform a check for each of the CM Model's management fields to see whether it is valid for political management as well.

Risk Management The identification of risks, which must be evaluated so that measures can be taken accordingly for risk prevention and minimization, is an important part of political management just as it is in business management. The key difference lies in the fact that the risks are primarily political and not economic. The range of political risks is almost infinite: they could be specialized (environmental or health risks) or related to political processes (candidates running for political office and before elections) or personal (political disagreements by top politicians in daily operations).

Corporate Management Corporate management, which is an (internal) normative level of business management, is also an essential management area for politics, for example through basic policy statements, party and election platforms as well as party congress resolutions and procedural regulations.

Relationship Management Relationship management in business pertains to (external) projects in the areas of transaction and business cooperation. In legal terms, transactions of exchange agreements and business cooperation are structured as partnership agreements. In Sect. 12.1.2.1, we have already highlighted the fact that, in political management, the transaction corresponds with political projects in legislation and governmental action as laid out in the government program. Of course, the relationship with voters, i.e. the public opinion and relationship to media (published opinions) can also fall under this area. Overall, it's about the credibility of the political players. If we viewed the political parties as companies ('enterprises'), then the business cooperation in politics is about a political cooperation in the form of a coalition ('joint venture') suitable for four years of governing. Mutual trust is the political currency here.

Knowledge Management Knowledge management concerns party-internal agreements and events as well as external communication processes between the negotiating partners ('cooperation') during the exploratory talks and the impact of other external occurrences. In this sense it is absolutely comparable with internal and external communication processes in business management.

Politics-Specific Management Field Political persuasion and majority management as well as power management emphasize, as already highlighted in Sect. 12.2.1.3, other aspects of the four of the CM Model's management fields, as is particularly exemplified with the case of relationship management. However, the divergent features occurring in political management (persuasion-, majority-, and power management) can be attributed to management of relationship and therefore don't necessitate the incorporation of new management fields when applying the CM Model to political management.

12.2.1.4 Conclusion About the Applicability of the CM Model to the Exploratory Talks and Coalition Negotiations

From the outcome of our inquiry, we can ascertain that an application of the CM Model and in particular its terminology can indeed provide invaluable insights into political management and, specifically, the coalition negotiations and the antecedent exploratory talks examined here. The discussion in Sect. 12.2.1.3 also illustrated that it is possible to apply the CM Model's management fields to political management.

We can now make use of the CM Model to examine the decision for or against the conclusion of the Jamaica coalition exploratory talks.

12.2.2 Preparation of the Decision

Task 1: Make a last-minute proposal for a decision for the evening of November 19, 2017 and give suggestions for the course of action to be taken.

One of the central preliminary questions for the FDP's decision requires a thorough risk analysis of their negotiating status, taking into account the election platforms of the political parties CDU/CSU, FDP, and the Greens during the federal election 2017. This will allow for a clear assessment of the FDP's negotiating leeway for the rest of the exploratory talks as well as their risks in terms of either satisfying their political profile in the results of the exploratory talks or possibly coming up short. This is all the more important since the final results of the exploratory talks would to a significant extent already constitute the draft (CM process step draft) of the coalition agreement for the formation of a Jamaica coalition in Germany. What follows is a more a detailed point of view of the FDP:

For the **FDP**, eliminating the solidarity tax in a significant trend reversal for national tax policies, a modernization of the state through a definitive abolition of the cooperation ban in educational policy, and the possibility of a liberal immigration policy could

all send a successful message to the electorate and increase the FDP's electability. For their future chances of success, they must also take into account the advantageous opportunity to decisively influence in EU financial policies through the Federal Ministry of Finance as well as potential successes in the areas of economic policies which traditionally affects the voter base of the Liberals (such as self-employed workers and freelancers, for example through the dismantling of bureaucracy), further subsidy decreases, possible negotiating successes regarding the start-up culture and a stronger approach to venture capital. At the same time, the question arises whether the key liberal negotiators can be successful in initiating a strong change in the prevailing political mood against a long-term chancellor in order to place themselves in a strong position in future elections. This would mean avoiding anything that could lead to a call for 'continuing on' in many political issues, which is quite an ambitious goal considering the FDP's proportional election results of 10.7% in the September 24, 2017 elections.

In order to understand the FDP's negotiating leeway, the most important goals of the **Union Parties (CDU/CSU)** must also be taken into account, which includes the formation of a federal government and the successful re-election of Chancellor Merkel as the head of the new government under the Jamaica coalition. This is considered a political goal in and of itself since this political formation has never existed before at the national level and a continuation of the long-term relative dominance of the Union parties in the aftermath of a highly fragmented party landscape in the German Bundestag (6-party parliament and the entry of the AfD, the so-called 'Alternative for Germany') would be an extraordinary success. Furthermore, the likely implementation of a restrictive refugee policy on the basis of an internal compromise between the union parties with a set maximum limit of 200,000 immigrants per year would be a tangible success in domestic policy. Another clear plus in the risk analysis would be the continuation of the foreign policy of the Chancellor's Office, in particular in European policy. The need to compromise on other political issues—even those that are painful compromises, such as climate protection, transport (emission-free policy) or agriculture (glyphosate ban) as well as any necessary staff losses in a three-way coalition (in less important ministries)—would take second place in comparison.

The most important goals of the **Green Party** are equally significant for understanding the negotiating context and indispensable as a starting point for the FDP to make its decision. In the case of the Green Party, the desire to govern after many years of being part of the opposition is clearly evident and their goal is to get their ambitious staff members into influential positions. The opportunity to have a dominant influence in the area of environmental policy with clear goals of climate protection could give the party base a good reason for joining the Jamaica coalition government. Of course, with the immigration policy they would need to make compromises at the expense of green goals and voters, but noteworthy successes are still possible for instance establishing permanent immigration in the next four years with options for limited family reunification as well as a more modern immigration policy. Furthermore, successes are possible in agriculture (glyphosate ban, organic farming), in education (abolition of the cooperation ban) as

well as in social areas (family and rental policy). It is also important to consider whether a political-strategic minority position in a Jamaica coalition could be successful during the course of the legislative period since in this configuration, the Greens tend to be in a minority position in all financial and economic issues as well as in transport policy.

Overall, an estimate of the political outcome with a view to the legal (lack of legally binding exploratory talks and coalition agreement), organizational (political management), business (political content), and ethical (credibility of the party; mutual trust among the parties) consequences for the FDP's decision consists of the following aspects:

- The lack of possibilities for implementing one's own goals (for example, the complete elimination of the solidarity tax),
- the lack of a common political ideology in a Jamaica coalition and the discernibly unwanted—but by the FDP desperately desired—change of policy and style as well as
- the basic lack of mutual trust among the parties.

Therefore, a failure of the exploratory talks can clearly be justified.

12.2.3 Making the Decision

12.2.3.1 Pro/Con-Analysis

On November 19, 2018 (Sect. 12.2.1), finding politically viable compromises for the most important areas of conflict is conceivable (**pro**):

- Coal and climate protection (most important issue for **the Greens**): Commitment to the climate goals for 2020 through concrete agreements on carbon dioxide reduction of 70 million tons, through the gradual shutdown of seven coal-fired plants, through a law implementing the phasing out of coal and the simultaneous creation of funds to cushion the resulting social structural problems, in particular for the heavily affected lignite and hard coal regions (e.g. Brandenburg and North Rhine-Westphalia).
- Flight and migration (most important issue for the **CDU/CSU**): Introduction of a so-called 'flexible cap' with an unofficial maximum immigration limit of 200,000 people per year from all regulatory circles (war refugees under the Geneva Refugee Convention, subsidiary protected persons, skilled immigrants, etc.) in addition to the creation of refugee reception centers. This includes a staggered, annual quota for family reunification for subsidiary protected persons with good prospects of integration, sufficient knowledge of German, and good opportunities on the job market. The opening of a so-called lane change for qualified asylum seekers with good prospects on the job market. The creation of a modern immigration law and the admission of the Maghreb states of Algeria, Tunisia, and Morocco to the list of safe countries of origin.

- Finances (most important issue for the **FDP**), in particular the solidarity tax: Gradual but not complete elimination of the solidarity tax within two legislative periods and beginning with an annual income of EUR 60,000.

Generally, a **"social-political umbrella" of the Jamaica coalition** is conceivable in the sense of a mutual corporate management. Considerations of this kind are made by the FDP politician Buschmann (head of the FDP parliamentary faction). He speaks for an unbureaucratic immigration policy, against provincialism in education policy (the federal government should assume more responsibility in education policy), and for greater investment in an effective, international climate protection policy with the goal of saving many more millions of tons of CO_2 than by subsidizing the Renewable Energy Act (see [25]).

The **triad of education, climate protection, and immigration** as well as fiscal soundness (no new debts) and a business-friendly politics could certainly be a sufficiently attractive program for the voters for the FDP.

After weighing the risks and opportunities of all three (four with the CSU) coalition partners of a possible Jamaica coalition at the federal level, it would be entirely possible and justified to make the following **decision proposal:**

Conclude the exploratory talks with the CM process step draft and begin coalition negotiations, continuing with CM process step draft until the conclusion of the negotiation and with the formation of a Jamaica coalition at the federal level.

On the other hand, the following aspects speak in favor of rejecting the conclusion of the exploratory talks (**con**):

The possible lack of consideration of the FDP's demands and the very challenging performance of the various party families in a tripartite and quadripartite alliance indicate a particular level of difficulty that would need to be considered earlier and more vigorously in the future in order to be successful. At times during the exploratory talks, the FDP had the impression they were not being given enough consideration between the two poles of the CDU/CSU and the Greens. This impression was grounded in particular in the areas of immigration limits (focal point for the CDU/CSU) and climate protection (focal point for the Greens). The fact that the top issue of the Liberals—the complete elimination of the solidarity tax within the legislative period of four years—could not be achieved in a compensatory manner, revealed a tactical negotiation imbalance which could pave the way for their withdrawal from the negotiations.

From the point of view of the FDP, other aspects of a longer-term nature and historical experience must be taken into account in their political decision-making. This includes

factors on the social relationship level (respect and consideration for mutually important concerns—'relational contracting'), in particular due to the past experiences of the then FDP Secretary General (2009–2011) and current Chairman Lindner (since 2013) with the CDU negotiator, Chancellor Merkel, in the past coalition between the CDU/CSU and the FDP 2009–2013, which ended for the FDP with their defeat in the federal elections of 2013 and their first time not joining the German Federal Parliament (Bundestag) (see [26, 23, 4]).

Looking towards the future, the FDP fears that it will once again be disadvantaged during the concrete implementation of the agreed upon projects, so that ultimately no successful corporate management is possible for the FDP. The overall foundation of trust is simply missing for this 'new formation' of a tripartite coalition.

This is also evident during the course of the Jamaica exploratory talks. To some extent, a sense of purpose seems to be missing from the tedious and complicated negotiation processes. For a long time, there was the general impression that although all the topics were being intensely negotiated on a fast-paced timetable, there was no clear, identifiable structure with the goal of finding compromises as quickly as possible for the decisive political issues at stake (see [27, 28]). On the other hand, towards the end of the negotiations, there was a discernible strategy of putting together all necessary compromises into an overall package during a long night of negotiations. However, the longer the negotiations on these crucial issues remained open, the greater the danger that the negotiations would fail. A lack of leadership is also to blame: "The week-long negotiations with the CSU, the Greens and the FDP were shaped by an obsession with details and frequent 'leaking' of the negotiating status to the press. Merkel was never able to bring structure and goal orientation to the discussions."[8] (see [7])

Ultimately what favors a failure of the exploratory talks is the fact that the potential effects of the division of the negotiation process into exploratory talks and coalition negotiation was not sufficiently taken into account and can no longer be taken into account in this particular political context. As already discussed in Sect. 12.1.2.1, the content of the coalition negotiation builds on a draft of the results of the exploratory talks, which already contains the basic structure of the future coalition agreement. Changes to this architecture generally don't take place during the coalition negotiation anymore (or only in cases of mutual agreement). From the FDP's point of view, a fundamental policy change must therefore already be discernible in the exploratory talks and in the draft of the exploratory talks. Otherwise, there is a risk of being disadvantaged during the concrete implementation of the exploratory talks in the coalition negotiation. During the concretization of the coalition projects, the FDP would be confronted with a well-coordinated governing apparatus already under discussion, which the CDU/CSU

[8]Own translation.

could make use of in order to gain greater negotiating power. A failure of the coalition negotiation would have been much harder to communicate to the public and would likely have damaged the FDP's credibility more than a failure of the exploratory talks.

The fact that information about the progress of the exploratory talks was continuously leaked to the press also increased the pressure on the parties to justify themselves, in particular in the case of the FDP, so that the foundations for a trusting cooperation between the parties during the exploratory talks was ultimately no longer possible. The desire to have one's own interpretation of the political negotiations accepted by the public resulted in an inability to guarantee a confidential exchange of arguments during the exploratory talks. A heightened sense of confidentiality regarding the status of negotiations as well as a stronger integration of the management fields within the conduct of negotiations could have minimized the risk of failure of the exploratory talks.

12.2.3.2 Final Risk Analysis

In summary, the conducted risk analysis allows the following conclusions:

The primary goals of the FDP's political agenda are as follows:

- elimination of the solidarity tax;
- liberal tax policy;
- modernization of the nation;
- improvement of the educational policy, and
- a more liberal immigration policy.

From the point of view of the FDP, the following goals were not reached during the exploratory talks:

- financial policy goals (complete elimination of the solidarity tax within the legislative period);
- a significant change in education policy (abolition of the ban on cooperation); and
- overall greater influence of the federal government on education policy.

There is every indication that the FDP will not be able to achieve sufficient substantive influence in the coalition negotiations and that the general policy change desired by the FDP thus does not seem to be realistic. Furthermore, there is no foundation of trust between the key negotiating persons, Merkel and Lindner, and the possibility of a greater consideration for Lindner's demands does not appear likely. Therefore, the key issue at stake here is the FDP's credibility in such a tripartite alliance.

12.2.3.3 Decision Proposal

The advisor of FDP party leader Lindner therefore suggests the following: Taking all of the arguments into account, in particular with an eye to the FDP's potential ability to assert their political goals in the CM process step draft during the exploratory talks and

even more so in the CM process step implement during the legislative period as well as the insufficient political basis of trust, working towards **a successful conclusion to the exploratory talks is not recommended**.

12.3 Implementation of the Decision

Task 2: Give concrete suggestions regarding how the FDP party leader should implement this decision proposal.

12.3.1 External Implementation

Before an official and surprising public announcement of failure in the night from the 19th to the 20th November, the impending failure could be discussed again and a more common scenario of diverging political forces could take place. The FDP should agree on an unsuccessful conclusion of the exploratory talks with a joint press appearance of all the negotiating partners. Political discussions should take place both internally within the party and then with the negotiating heads of the CDU/CSU and the Greens on the night of November 19, 2017. In this way, at least the scandalous character of the last night of negotiations could be avoided.

12.3.2 Internal Implementation

The party head, Lindner, could discuss the next steps with his closest advisors and members of the FDP's leadership circle so that the FDP's actions in this difficult position could at least predominantly convince its own party base. The party leader could first discuss the perception of the negotiation process with his deputy negotiator, Kubicki, and, if he agrees, inform the rest of the negotiating group as well as the party heads about the intended procedure in order to show a unified stance to the public and overcome all disadvantages the difficult circumstances might pose for the party.

12.4 Process Optimization

Task 3: Offer the party leader ideas for how to optimize their conduct in future exploratory talks and coalition negotiations.
Within the **framework of relationship management**, the following empirical values should be taken into account for future exploratory negotiations on the federal level in new tripartite or quadripartite constellations:

- In the future, the difficult performance of the respective party families in a tripartite or quadripartite alliance should be considered earlier and more vigorously in order to reach a successful conclusion to the negotiations. In protracted and complicated negotiations such as exploratory talks, a clearly discernible structure is required with the goal of being able to reach compromises in the decisive policy areas as quickly as possible. In other words, an earlier assessment which takes place within one to two weeks could quickly identify the need for further-reaching compromises even on substantive party interests.
- Risk management and party (corporate) management should be sufficiently tied to knowledge management since the division into two negotiation processes may not make it sufficiently clear which effects the negotiated arrangements of the exploratory talks have on the concrete project design of the coalition negotiations.
- Negotiating discipline is especially important in light of the complexity of the exploratory talks. The wish to shape the public's interpretation of the political negotiations must not lead to a situation in which the confidential exchange of arguments during the exploratory talks is no longer guaranteed.
- The leaking of (interim) negotiation results to the press must be avoided. Otherwise it could lead to a breach in the foundations of a trusting cooperation between the parties in the exploratory talks.

Overall, greater confidentiality regarding the status of negotiations and stronger integration of the management fields, in particular knowledge management, with the execution of negotiations could considerably minimize the risk of failed exploratory talks.

12.5 Actual Execution

In fact, Lindner presented himself to the press on November 19, 2017, and regretted that there was not a sufficient basis of trust between the Unions, the Liberals, and the Greens: "It has become evident that the four negotiating parties are not able to form a common vision for the modernization of our country and, above all, that there is no common basis of trust. A common basis of trust and a shared vision would have to be the prerequisites for a stable government." This was followed by the pivotal statement: "It is better not to govern than to govern wrongly." (see [29]).

Nothing more is known about the facts of the FDP's internal decision-making process so that we cannot make any more statements about the knowledge management within the FDP, i.e. about the concrete, internal discussion process which led to the decision to end the exploratory talks unsuccessfully.

Thus, on November 19, 2017, the Jamaica negotiations had officially failed (see [26, 10]) and the process of government building was delayed by several weeks, although the political debate about a new grand coalition began immediately (see [30]). However, a particularly difficult constellation initially arose which was characterized by great

uncertainty on the part of the SPD in terms of whether they should continue their course as the opposition or if—under certain conditions—joining a grand coalition would be conceivable after all. There was also a broad range of suggestions made within the Union, including a Union minority government or a joint government with the Greens. The strong position of the Federal President (in contrast to the otherwise rather representative function) in the election of the Federal Chancellor in accord with Article 63 of the Basic Law was also discussed politically and constitutionally. Federal President Steinmeier was very committed during the transition phase and had many intense exchanges with the political heads of the parties, communicating his conviction against a minority government and for a new grand coalition (see [17]).

On December 15, 2017, the SPD agreed to begin exploratory talks with the Conservatives Union for a new grand coalition. These began, after more preliminary discussions in December 2017, between January 7 and 12, 2018, with a 28-page basic agreement delineating all of the important political issues (see [31]). The coalition negotiations officially began on January 22, 2018 and ended on February 2, 2018 with a very detailed 177-page coalition agreement which included all personnel assignments [32].

At the end of the negotiation marathons, Angela Merkel was re-elected as the Federal Chancellor on March 14, 2018 (see [33]).

12.6 Learning Outcome

12.6.1 CM Value for the Case Study

The CM Model's application to political management revealed itself as both feasible and useful. The comparison of a (political) coalition with a contractual joint venture in the area of business management built a bridge that allowed us to connect political management with the core management fields of the CM Model (risk management, corporate management, relationship management (area of transaction and business cooperation) and knowledge management). The differences between political management and business management, for example in the areas of power, majority, and persuasion management, supplement the CM Model perspective but do not transform it. On the contrary, the CM Model makes it clear that comparable standards must be met in order to allow for a successful political management. The particular characteristics of political negotiations, which are exemplified in the division of the negotiation process (exploratory talks and coalition negotiation) as well as the other particularities of political management, are also revealed through the CM Model which ultimately allow for an optimization of the negotiation process.

The CM Model also illustrates that the results of the exploratory talks, in large part through the high public awareness of these results, generate a strong binding effect and thus can serve as an instrument for political management in the subsequent coalition even if the agreements have not laid out in a legally binding document. This makes it

necessary to pursue a consistent plan regarding the content and course of the negotiations even at this early stage of the negotiations.

The present case study deals with the CM process steps plan and draft, in which the political management of coalitions on a federal level must distinguish between exploratory talks and the subsequent coalition negotiation and, in particular, shed light on the political risks (risk management) which must be taken into account from the point of view of party credibility ('enterprise').

The possible division of the negotiations into two parts requires a close coordination of the relevant management fields with the negotiators of the parties ('enterprises') so that knowledge management, with regard to internal processes of a party but also external processes of cooperation between the negotiating parties (business cooperation), must be given special consideration.

In terms of a plausibility check, the internal project management requires that the feasibility of the exploratory talk results in everyday political life (incidental relationship management in the CM process step implement) is checked in relation to the compatibility of political guidelines (corporate management).

The external project management (business cooperation) requires a strong negotiation process that can withstand the pressure of a public that is constantly informed of the interim negotiation results, which can have a counter-productive influence on the trust relationship between the negotiating partners.

The complex interaction between the various political levels requires an effective knowledge management during the CM process steps plan and draft. It is a matter of reconciling the exploratory talk results with the 'political superstructure' of the parties (party platforms and decision-making base: corporate management) and the various expectations of interest groups in order not to jeopardize the party's credibility before even beginning the political implementations of a governing coalition.

12.6.2 Case Study Value for the Reader

The reader understands the common negotiating structures in the areas of business and politics and recognizes the particular complexity of political negotiations.

The reader recognizes that a certain amount of flexibility is required in the drafting of contracts and that in some cases only guidelines can be laid down as is done with incomplete contracts in business. Just as in business negotiations, mutual trust plays an extremely important role since the implementation can often only be defined in general terms in order to be able to take unforeseeable political circumstances into account. Furthermore, the ability to effectively communicate a problem to interest groups—in this case voters—is even more important with political projects than business projects in order to be able to successfully campaign for electoral votes.

The significance of exploratory talks as a part of the CM process steps plan and draft becomes clear since the coalition negotiations build upon the results of the exploratory

talks and already represent the basic principles and interests of the negotiating parties. Thus, the CM process step plan and in principle the CM Model step draft for the coalition negotiations are already complete at the conclusion of the exploratory talks so that these can be built upon and a final agreement can be drafted during the coalition negotiations.

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Matrix of Case Studies

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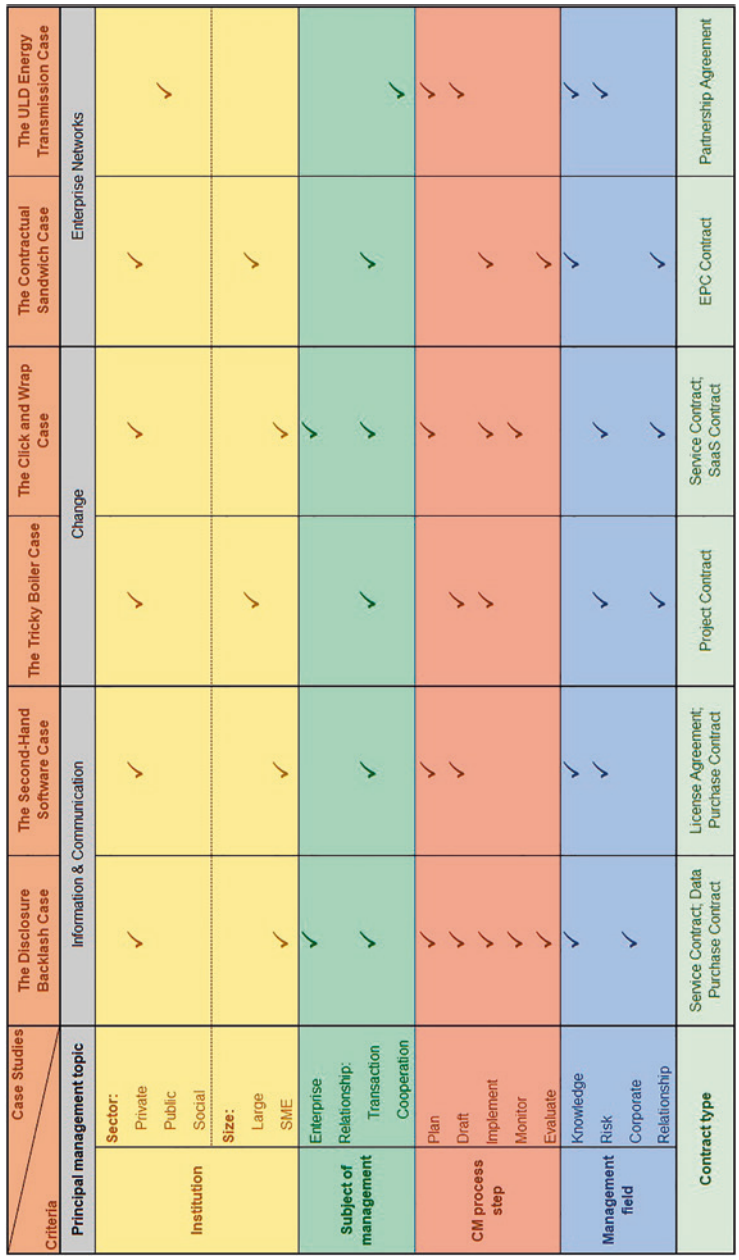

Case Studies / Criteria		The Disclosure Backlash Case	The Second-Hand Software Case	The Tricky Boiler Case	The Click and Wrap Case	The Contractual Sandwich Case	The ULD Energy Transmission Case
Principal management topic		Information & Communication		Change		Enterprise Networks	
Institution	**Sector:** Private	✓	✓	✓	✓	✓	✓
	Public						
	Social						
	Size: Large			✓		✓	
	SME	✓	✓		✓		
Subject of management	Enterprise	✓			✓		
	Relationship: Transaction	✓	✓	✓	✓	✓	
	Cooperation						✓
CM process step	Plan	✓	✓		✓		✓
	Draft	✓	✓	✓			✓
	Implement	✓		✓	✓	✓	
	Monitor	✓			✓		
	Evaluate	✓				✓	
Management field	Knowledge	✓	✓			✓	✓
	Risk		✓	✓	✓		✓
	Corporate	✓					
	Relationship			✓	✓	✓	
Contract type		Service Contract; Data Purchase Contract	License Agreement; Purchase Contract	Project Contract	Service Contract; SaaS Contract	EPC Contract	Partnership Agreement

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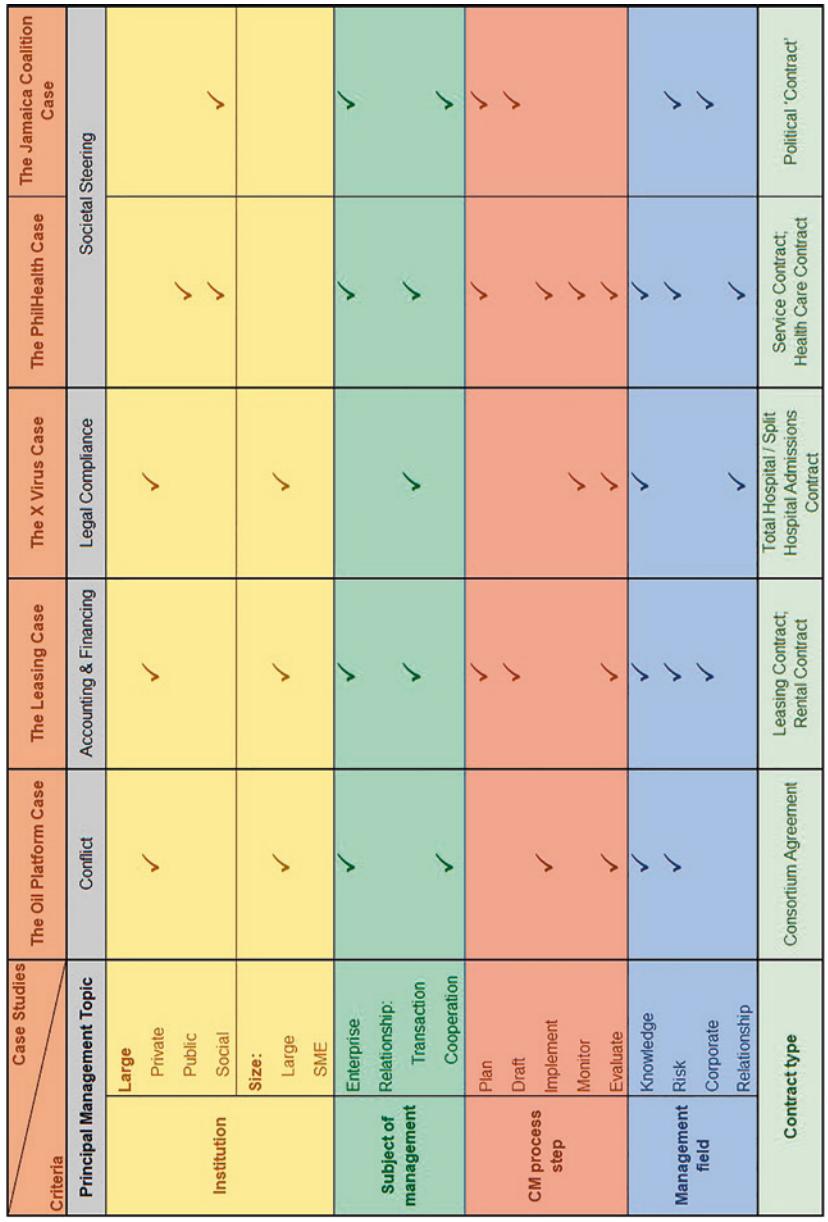

Criteria \ Case Studies		The Oil Platform Case	The Leasing Case	The X Virus Case	The PhilHealth Case	The Jamaica Coalition Case
Principal Management Topic		Conflict	Accounting & Financing	Legal Compliance	Societal Steering	
Institution	**Large**					
	Private	✓	✓	✓		
	Public				✓	
	Social				✓	✓
	Size:					
	Large	✓	✓	✓		
	SME					
Subject of management	Enterprise	✓	✓		✓	✓
	Relationship:					
	Transaction		✓	✓	✓	
	Cooperation	✓				✓
CM process step	Plan		✓		✓	✓
	Draft		✓			✓
	Implement	✓			✓	
	Monitor			✓	✓	
	Evaluate	✓	✓	✓	✓	
Management field	Knowledge	✓	✓	✓	✓	
	Risk	✓	✓		✓	✓
	Corporate		✓			✓
	Relationship			✓	✓	
Contract type		Consortium Agreement	Leasing Contract; Rental Contract	Total Hospital / Split Hospital Admissions Contract	Service Contract; Health Care Contract	Political 'Contract'

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Short Biographies of the Authors

Daniel Arias Aranda

Daniel Arias Aranda is a Professor of Management at the Faculty of Economics and Business at the University of Granada. His research has focused on Operations Management, Innovation Management, Business Management Services, the relationship between the implementation of systems Enterprise Resource Planning (ERP) and Advanced Management and Supply Chain Simulation. Daniel Arias Aranda holds a PhD in Economics and Business Studies from the Complutense University of Madrid.

Maria C. G. Bautista

After international stints working, consulting, and project managing with bilateral and multilateral organizations on health financing and development for a decade and a half, Maria CG Bautista returned to academia in 2016 as Professor at the Ateneo de Manila University's Graduate School of Business (AGSB). As de-facto Head of the Research Unit of AGSB, she teaches, conducts, mentors and publishes research on health economics and financing, social protection, and economic development (gender and equity, education). Maria Bautista holds a PhD in Economics.

Bert Eichhorn

Before his appointment as professor for International Law and Business Law at SRH Hochschule Berlin, Bert Eichhorn worked as a legal consultant at the EU Parliament and as a lawyer. He has published numerous articles in national and international scientific journals in the area of Contract management and international law. He is the managing director of the Contractual Management Institute at SRH Hochschule Berlin. Bert Eichhorn holds a doctorate in law.

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Sarfaraz Ghulam Muhammad

Sarfaraz Ghulam Muhammad is an IT analyst, lecturer and a research scientist from Berlin, Germany. He has been active in research and theoretical science since 2013 and has achieved awards and honorary positions for his research contributions including the International Academy, Research and Industry Association (IARIA) award for best conference paper. His areas of research include cloud computing, open-source software and smart-items.

Antonio Giarra-Zimmermann

Antonio Giarra-Zimmermann is a political adviser in the state chancellery of Rhineland-Palatinate. He started his career in European affairs as an assistant of an MEP in Brussels and later became Head of Department for Federal Affairs and therefore a specialist of national politics and legislation between the German Bundestag und the Federal Council in Bonn and Berlin.

Ulrich Hagel

Ulrich Hagel is Global Head of Contracts & Commercial Management Procurement and Global Head of Litigation at Bombardier Transportation, mediator and attorney-at-law (KonsensKanzlei). He is also Academic Director of the MBA program “International Commercial & Contract Management” at the Dresden International University. Ulrich Hagel holds a doctorate in law.

Nikolaus Högenauer

Before joining the legal department of Linde Engineering in Munich, Germany, Nikolaus Högenauer held senior management positions in Linde’s contract management, subcontract management and commercial management. For several years, he worked in different positions for Linde Engineering's subsidiaries in the United States. Nikolaus Högenauer holds a doctorate in law and is admitted to the German bar.

Carsten Morgenroth

Carsten Morgenroth was born in 1973. He has been working as Head of the Legal Department at the Ernst-Abbe-University of Applied Sciences Jena, Germany, since 2005 and additionally became Vice Chancellor of the University in 2007. A considerable

part of his legal work for the university consists of reviewing and drafting contracts of all kinds, especially with respect to scientific projects. Carsten Morgenroth holds a doctorate in law and studied in Jena and Speyer, Germany and Kansas City, USA.

Ralph Schuhmann

After holding a senior management position in industry, Ralph Schuhmann now is a professor of Business Law at Ernst-Abbe-Hochschule in Jena, Germany. He is the scientific director of the Contractual Management Institute at SRH Hochschule Berlin and has published various articles on contract law and contract management. Ralph Schuhmann holds a doctorate in law.

Ognyan Seizov

Before joining the Contractual Management Institute at SRH Hochschule Berlin, Ognyan Seizov was a postdoctoral researcher for multimodal political communication at the University of Bremen and a visiting postdoctoral fellow at the Department of Comparative Media Studies/Writing at MIT in Boston, Massachusetts. He has published on informative and persuasive communication online, digital media production and reception, and multimodal media content analysis. Ognyan Seizov has a PhD in Communication Science.

Vladimir Stantchev

Vladimir Stantchev has been the executive director of the Institute of Information Systems at SRH Hochschule Berlin since March 2012. His research interests are focused in the areas of Cloud Computing, Cyber Security, IT Governance, and IT Management. He has published over 100 international publications and is co-editor of multiple international journals. Vladimir Stantchev holds a PhD in computer science from the Technical University of Berlin (TU Berlin) and was a Fellow at the University of California in Berkeley, CA, USA (UCB).

Markus Ulrich

Markus Ulrich is the Managing Director of PORTAL Steuerberatungsgesellschaft mbH, Cologne and has been a partner in the law firm Schuster & Partner GbR, Cologne since 2000. He holds a degree in business administration and has obtained qualifications as a tax consultant and auditor. His focus is on auditing annual financial statements and tax consulting for international companies.

Frank Wittig

Frank Wittig is a research associate and worker's council member at SRH Hochschule Berlin. In addition to administrative and academic coordination, he teaches courses in project management, intellectual property protection, business & legal English, as well as academic thesis proposal writing. His research interests encompass hospital operations management, real-time location & tracking and indoor position positioning systems.

Alexander J. Wulf

Alexander J. Wulf is a professor of Business Law at SRH Hochschule Berlin—The International Management University. He is interested in the interdependence of law and economics, the role of law and legal institutions in economics and the application of empirical methodology to the study of law. His research focuses in particular on the empirical analysis of commercial law in the European Union. Alexander Wulf holds a doctorate in law and a PhD in Political Science.

Inventory of Contract Knowledge

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