

Postmortem on a Public Sector Contract Collapse: The State of Indiana's Welfare Modernization Failure

Carolyn J. Heinrich
Vanderbilt University

Deanna Malatesta
Indiana University

March 2022

Abstract

Government agencies have increasingly turned to complex multi-actor contracts and public-private partnerships (PPPs) to outsource social services. When these contracts do not deliver as promised, the consequences can be severe, especially for vulnerable populations. Various theories and models have been leveraged to understand the problems that arise in sustaining cooperative relationships of the sort embodied in complex contracts, including new thinking that proposes a “formal relational contract.” We draw on these theories and models to develop and assess propositions in the case of a complex, contractual agreement between the State of Indiana and an IBM-led consortium that was designed to modernize and operate the state's welfare services system. We undertake a case study analysis to illuminate, confirm or disconfirm, and advance theory on contracting out through complex PPPs, utilizing rich data from public documents and reports, interviews with key informants, court filings, depositions and rulings, and other internal correspondence and news accounts spanning more than a decade. We assess the formal contractual and informal relational aspects of the State of Indiana-IBM PPP, considering the adequacy of the contract design and how the decision to ultimately sever the relationship was reached. Resulting insights have value for policy makers considering how to improve the outsourcing of critical social services; for government officials who craft complex multi-party agreements, and for public managers involved in sustaining cooperation in PPPs.

INTRODUCTION

In 2006, the State of Indiana set out to modernize and improve the state's public welfare system, with Governor Mitch Daniels calling for a revamping of "America's worst welfare system," one that, in his words, was "broken" and "plagued by high error rates, fraud, wasted dollars, poor conditions for its employees, and very poor service to its clients." Toward that end, the state established a \$1.3 billion dollar contract (Master Services Agreement) with the International Business Machines (IBM) Corporation and a coalition of subcontracted partners. Governor Daniels showcased the project in his 2008 re-election campaign and avowed that privatizing the system's management would lead to the improvements in performance and efficiency that the state desired. The project correspondingly received considerable attention among politicians, news outlets, academics, and ultimately, the court system. The intent in designing the Master Services Agreement (MSA) was for it to govern the Indiana welfare system's management—in particular, eligibility determinations—for 10 years, yet the agreement was severed less than three years later. In the words of the Governor, "the project did not work because the concept itself was flawed."

Government agencies have increasingly turned to complex, multi-actor contracts and public-private partnerships (PPPs) to outsource social services, including in public welfare services delivery (GAO, 2002). When these contracts do not deliver the promised service and performance improvements, the consequences can be quite severe, especially for vulnerable populations (Heinrich & Choi, 2007), such as Indiana welfare recipients in this case. In this research, we undertake a theory-based analysis to perform an "autopsy" of the contract and relational collapse between the State of Indiana and the IBM coalition. Our primary aims are to illuminate and scrutinize the complex formal (legal) and informal, relational aspects of the

agreement (i.e., those that could not be enforced by a third party such as the courts [Gibbons, 2005]) and thereby derive insights and lessons for improving PPPs, contract design, and alliance management, particularly for (envisaged) longer-term contractual relationships. The Indiana-IBM case presents a valuable opportunity to explore issues of public-private contract design and execution in depth, given: (i) the high-profile nature of this case and court proceedings that generated substantial, publicly accessible documentation of formal and informal aspects of the relationship among the parties; (ii) the evolving contractual and informal provisions of the agreement that allow for analysis of the dynamics of public-private contracting and the performance metrics that guided decision making over time; and (iii) its ongoing relevance as the role of public-private contracts in the management of core functions of public assistance programs, including eligibility and access to benefits and services, continues to expand (McAfee & McMillan (2019).

In framing this analysis, we draw on multiple theoretical models—economic theories of contracting, relational contracts, and behavioral psychology—to characterize the contractual features and exchange relationships among the partners in this complex PPP. Our theory-informed analysis draws on interviews, contractual documents, court filings, depositions, press accounts and internal correspondence to illuminate how the transactional contract that buttressed this PPP unfolded and then fell apart, as well as the different partners’ perceptions of what went wrong. A key insight derived from this case is that the conventional approach to PPP contracting employed by many governments today is outdated and may undermine the sustainability and success of PPPs. Traditional (formal, tightly structured) contract arrangements frequently fail to adequately account for the nature of “new governance” (Salamon, 2011) or the realities of “the new economy” (Frydinger et al., 2021). These include shared public authority and lengthening

chains of delegation; complex, multi-layered systems of relationships, with interdependencies among diverse actors who may be collaborators one day and competitors the next; and an increasingly volatile economic environment that is characterized by growing market interconnectedness and accelerating risks. To improve the chances of PPP success, contracting parties need to not only understand the implications of the new governance and new economy, but also recognize the psychological tendencies and inherent limitations of individual decision makers in the relationships.

In the next section, we begin with an overview of these theories and their relevance to the State of Indiana-IBM case, and we follow with additional information on the case, including the timing of key decisions, the phases of implementation and rollout, and the performance metrics tracked. We continue with the conceptual exposition and analysis of the case and the features of the contract (formal and informal) that guide our understanding of the Indiana-IBM contract breakdown and inform explanations for the contract outcome. We then discuss the extent to which our analysis allows for the generalization of these case findings to similar cases of complex, public-private contracting and conclude by drawing out broader lessons for public managers and the public management research community to inform improvements in public-private contracting and guide future research.

THEORETICAL FRAMING OF COMPLEX, PUBLIC-PRIVATE CONTRACTUAL RELATIONSHIPS AND THE STATE OF INDIANA-IBM CONTRACT

Formal Contracts

If well-structured and managed, PPPs may offer the opportunity to expand public service capacities, as well as the reach, efficiency and effectiveness of services delivery, while also allowing for financial and operational risks and responsibilities to be shared with private

partners. At the core of a typical PPP is a formal contract that specifies the partnership goals, roles and responsibilities of the partners, and terms and conditions of the collaborative arrangement, (e.g., performance expectations, cost-sharing provisions, stipulations for renegotiation, etc.). In addition, the formal contract provides guidelines for communication, negotiation, and the sequencing of tasks. By including these standard provisions, formal contracts establish critical controls and coordination functions for executing the work (Ryall & Sampson 2009; Schilke & Lumineau 2018).

Economic theories of contracting focus on a key challenge in establishing a durable contractual arrangement: the difficulty of specifying in advance a *complete* contract—one that fully addresses contingencies or circumstances that might arise and affect attainment of the contract outcomes and stipulates the course of action that should follow their occurrence (Hart & Moore, 1988). In public welfare programs, it is particularly challenging to establish a sufficiently clear and enforceable contract, as external factors such economic cycles and the availability of employment opportunities and natural disasters can affect the need for temporary cash assistance. Drawing on Williamson's (1981) transactions costs framework, Brown and Potoski (2003) add that services such as public welfare require more specialized investments to produce them (asset specificity) and the outcomes or value added of these services are more difficult to observe or evaluate (a lower level of service measurability), magnifying the challenges of writing an effective performance-based contract. In these circumstances, contract negotiations become critical, as the contracting parties determine the terms or mechanisms (cost-sharing provisions, performance incentives) that will allow them to address the problems associated with contract incompleteness. However, research also suggests that concerns about possible oversights, gaps, omissions, or ambiguities in contracts often lead contracting parties to take measures or engage

in behaviors that may be counter-productive to a constructive collaboration and efficient outcome (Covey & Merrill, 2006).

Indeed, in crafting the MSA for the modernization of Indiana’s welfare system, the parties concurred that not all the uncertainties could be accounted for in the formal contract. Indiana’s Family and Social Services Administration (FSSA) was aware that the undertaking would be difficult when they decided to modernize the eligibility system and issued a Request for Information (RFI) in October 2005 to solicit proposals; James Robertson, FSSA Director from the Division of Family Resources commented: “No one had done this successfully, as far as we know” (Marion Superior Court Civil Division 10, Findings of Fact, Conclusions of Law and Judgment for IBM, July 2012, Exhibit 3207, 2). It was recognized that the new system would be more than a “brand-new workflow and document management system... [and that success would require] changing the ingrained habits of [many] employees and constituents” (Exhibit 190A, IBM-IN00255540). Over a million welfare program applications were being processed each year, involving complicated, highly individualized determinations based on unique facts and circumstances (Harris testimony, TR: 1935:25-1936:1; Marais testimony, TR: 1937:19-1938:5).

In January of 2006, IBM—in a coalition of parties designated as the “Hoosier Coalition for Self Sufficiency”—submitted a response to the RFI. The parties that came to the table had considerable expertise in crafting and negotiating complex contracts, and the State of Indiana brought in a high-powered team of lawyers to assist in writing contract specifications. The determination of the rights of control over the assets used in welfare services provision and the authority or decision-making power for handling noncontracted contingencies (Hart, Schleifer & Vishny, 1997) that were specified in the formal contract ultimately proved critical to the PPP outcome. In December 2006, the parties signed a \$1.3 billion dollar, 10-year MSA consisting of

more than 160 pages and numerous exhibits and appendices, as well as 24 schedules clarifying the parties' responsibilities and detailing performance metrics and incentives.

The State of Indiana-IBM formal contract

The MSA is explicitly between two parties: the “State,” *acting on behalf* of the FSSA (of which it is the regulatory supervisor), and IBM, identified in the MSA as the “Vendor.” IBM subsequently subcontracted with a multitude of private sector vendors to execute the work of the MSA. A depiction of the Hoosier Coalition charged with the project implementation appears in Figure 1.

[Insert Figure 1 here]

In the Hoosier Coalition hierarchy, major decisions came from the Governor and were communicated to the FSSA. Lines of authority and communication then went from the FSSA to the primary vendor, IBM. Although the composition of the subcontractors changed as the project unfolded, Figure 1 shows the hierarchy as contemplated in the MSA, with ACS, as a major actor in a complex network of subcontractors, reporting to IBM.

The FSSA (as articulated in the MSA) is responsible for four key social welfare programs: Medicaid, Food Stamps, Temporary Assistance for Needy Families (TANF), and the Child Care and Development Fund (CCDF). The State sought to improve access to these programs and the responsiveness of the welfare system by transforming the process “by which information needed or related to making eligibility determinations is collected, organized and managed” (the DFR Eligibility Intake and Determination Preparation process) (MSA, p. 1). In entering into the public-private contractual agreement with IBM, the State expected the vendor to develop and provide technology and systems for receiving and processing applications for public assistance, including the collection and verification of data, document imaging and management

required for eligibility determination, and in some counties, operating and managing Vendor Service Locations, although “certain State Retained Activities” remained the State’s responsibility, as discussed below (MSA, §1.1.1 (2)).

The MSA is a performance-based contract replete with clauses that exemplify contract control functions and the parties’ concerns about the potential for “hold-ups,” that is, apprehensions that one party’s performance would be held up by the other (Hart & Holmström, 2016). In addition, the State required its contracting officials to include numerous boiler-plate provisions intended to decrease risk to the state, as set out in contract manuals. Examples of coordination clauses include the requirement that “IBM is the sole point of contact with regard to contractual matters,” (MSA § 14.6.2), the specifications for change order processes (MSA §3.12), and the priority for handling certain change orders (MSA §3.12.17). These clauses are intended to constrain behavior, but they also have a downside. The more fixed terms a contract includes, the more rigid and less amenable to adjustments for noncontracted contingencies it becomes—which is particularly a problem in PPPs. Moreover, Covey and Merrill (2006) point out that a lack of trust between contracting parties further “taxes” the formal and informal relationships, including through excessive rules and regulations, unwarranted duplication, political maneuvers and hidden agendas, disengagement, turnover and churn, and outright fraud. While the parties to the MSA sought to achieve some balance between rigidity and flexibility and to be “pragmatic” about how to define success (Dreyer, 2012, 15)—anticipating the challenges of executing a project involving more than 100 local offices, the integration of new technology, and employee changes and training—in its final form, the contract included numerous, specific performance standards (MSA §3.8), along with extensive reporting requirements (MSA §3.13.1). More generally, the transactional contract design reflects a

hierarchical and legal (vs. professional) orientation of the relationship among the primary and subcontracted partners in the PPP that may have predestined the Hoosier Coalition for failure (Romzek & Ingraham 2000).

Relational Governance

Although PPPs can be managed to realize an appropriate allocation of risks between public and private partners throughout the life of a project, it often requires reliance on relational governance mechanisms as well, such as trust, reputation, reciprocity and other forms of social relations that facilitate ongoing interchange and dynamic collaboration (Macneil, 2001). Particularly when government entities enter into a longer-term contractual relationship—such as the intended 10-year MSA—traditional “command-and-control,” compliance-oriented approaches to managing a PPP are more likely to result in adversarial relationships among the partners (Bertelli & Smith, 2010). Alternatively, relational contracts supply informal incentives to motivate cooperation, namely, the value of future relationships that serve to fill in the blanks where expectations are unwritten, allowing parties to use judgment as circumstances change (Baker, Gibbons and Murphy, 2002, p.39). In the absence of an enforceable contract, relational contracts rely on credibility among the parties—the expectation that the partners will not renege on their promises—and clarity (or mutual understanding) of what each partner has promised to do (Gibson & Henderson, 2012). In effect, relational contracting handles the problems associated with incomplete contracting in an entirely different way, shifting away from legal mechanisms and renegotiation and toward relationships based on trust, cooperation, and the motivation to preserve (rather than renege) on the collaboration (Sclar, 2000; Bertelli & Smith, 2010).

At the same time, this does not imply that there is no role for formal governance mechanisms in a PPP; in fact, by aiding in aligning incentives and creating reward and

coordination mechanisms, formal governance can serve in keeping the overarching relational contract within its self-enforcing range (Klein 1995; Baker et al. 2002, 2011). “The key to governance in a contracting state,” argue Bertelli and Smith (2010, p. i28), “is to effectively manage both the formal contracts and the relationships with contractors.” This also reflects that relational contracts have their own limitations. Of course, by their nature, relational contracts are challenging for courts to enforce; relational contracts are not a “spot market deal,” comments Speidel (2000, p. 823), and their terms are not static. Without a clear beginning or end date, there is ambiguity about when norms are expected to kick in or when a party is no longer liable or held to the expected behavior. Furthermore, the boundaries of a relational contract may also be ambiguous; many persons and organizations may be involved in a relational contract, whereas a formal conventional contract is bounded by the signatories and accompanying legal claims. In fact, Bertelli and Smith (2010) contend that a key role of the public manager in relational contracting is to maintain credibility across organizational boundaries.

More broadly, we understand from theory and practice that both formal and relational contracts embody valuable mechanisms for guiding contracting party behavior, and that “every contract is embedded in social relations governed by strong social norms” (Frydlinger et al., 2021, p. 52). Yet neither the formal transactional contract nor the informal relational contract adequately support the contracting parties in addressing the complex challenges faced in PPPs today. Moreover, both are grounded in standard economic models of choice that conceive of parties as rational actors who are expected to make decisions that maximize their utility and balance risks and benefits. In reality, humans often make choices that appear to deviate from any consistent utility function (Tversky & Kahneman, 1979), and economic theories of contracting fail to account for limits in cognition and psychological processes, i.e., human’s bounded

rationality (Simon, 1957). We need to bring in psychology and behavioral economics to better understand what motivates parties to act in ways that appear inconsistent with their material interests.

Behavioral Decision Theories and the Formal Relational Contract

Behavioral decision theories acknowledge that decision makers may not have all of the information they need to make rational choices or may not be able to process all of the information available to them. In compensating for such shortcomings, individuals often rely on mental shortcuts or heuristics. As posited in prospect theory, individuals will attempt to weigh gains and losses in deciding between alternatives, but the outcomes deviate from expected utility theory predictions, in part because decision makers give more weight to losses than to gains (i.e., loss aversion) (Kahneman & Tversky, 1979). Furthermore, in assigning value to their options, they will use a reference point rather than considering them in absolute terms, that is, placing a higher value on marginal gains (in reference to their starting point) than on the absolute value of outcomes (Homans, 1974). Frydlinger and Hart (2019) apply this concept of reference points in considering incomplete contracts and contracting parties' compliance with contract terms, which they argue cannot be explained by the contracting language alone. That is, even the most explicit contract terms and best designed incentives will only go so far in predicting whether contracting parties choose to cooperate or not cooperate.

More specifically, when a contract is incomplete, by definition the parties have not communicated their expectations as to what will happen (or how the formal arrangements will change) when circumstances change. The parties will nevertheless have expectations about how the agreement should change or what is an acceptable outcome based on their subjective reference points and perceptions of fairness, or their sense of equity or fair treatment in the

context of the collaboration (Thibault & Walker, 1975; Tyler, 1990; Walker et al., 1974). “The ex ante contract provides a reference point relative to which the parties evaluate the ex post outcome” (Fehr, Hart & Zehnder 2009, p. 562). The parties will stop cooperating in the contractual relationship when they perceive the terms of the agreement fall short of their expectations as gauged by their reference point. As contract performance declines, attribution may also play a role, as was observed in the collapse of the Hoosier coalition and the formal contractual relationship (MSA). If one party perceives the other party as being responsible for the breakdown or perceives that the other party did not make the expected effort to correct the situation—as the State of Indiana-IBM court case exposed—they may behave by reciprocating or “shading.” Shading can be conscious or unconscious behavior. A simple example of shading occurs when a party compromises on quality. Yet shading may also take the form of free-riding or deliberately undermining cooperation (Frydlinger et al, 2021). If there is a multiplicity of outcomes by which the contract performance is judged, the probability of shading increases, as it is more likely that at least one party will be dissatisfied with results. The application of game theory to circumstances where the parties believe they have been treated unfairly leads to a similar result, where the parties reject offers they perceive as unfair (even if it is in their best interest to accept), and rejection is viewed as a form of punishment (Camerer & Thaler, 1995; Fehr & Gächter, 2000).

Relational governance thus necessitates psychological engagement, as partners will bring their own subjective interpretations about what is contractually specified and will also have different perceptions about what behaviors are acceptable or aligned with contractual specifications (Macneil, 1985; Rousseau, 1989). In essence, the partners form a psychological

contract alongside of the formal transactional contract that affects how they interact, including the cognitive dimensions of communication and decision making (Guercini et al., 2014).

In contracting literature a new emerging form of contractual arrangement, known as a *formal relational contract*, is increasingly receiving attention (see, Frydlinger et al, 2021). A formal relational contracting approach aims to solve the problem of incomplete contracts by bringing together theory on the cognitive and psychological elements of contract behavior (e.g. self-serving bias and reference point valuations) and prescribings guiding principles to reinforce the formal and relational aspects of the contract.¹ The guiding principles embody a “duty of good faith,” already legally recognized in some jurisdictions. In essence, the parties clarify what good faith means to make it legally binding. The practice of establishing guiding principles is in itself valuable to the contracting parties; it involves a cultivation of trust and cooperation at the outset, which provides a foundation for keeping the contracting parties’ interests aligned over time (Frydlinger et al., 2019). The contractual framework is intentionally designed to be flexible and responsive to the dynamics of collaborative work, where the rules or guiding principles of the relationship are negotiated first, and the parties then work together (via relationship building) to address challenges or conflicts that arise.

The nascent literature on this type of contractual arrangement suggests that a formal relational contract is particularly well-suited to complex, multi-party, longer-term relationships—characteristic of many PPPs—whereas those that are primarily transactional and time-limited can be well-served by a traditional (formal) contract. While this literature identifies basic principles that should undergird a successful formal relational contract—such as reciprocity, autonomy, honesty, loyalty, equity, and integrity—there is limited real world

¹ Frydlinger et al.(2021) advocate for the adoption of six guiding principles (reciprocity, autonomy, honesty, loyalty, equity and integrity).

evidence, outside of private sector case studies, on how the relational and psychological aspects of a contract evolve alongside of the formal contract. In the analysis we present, we describe the unfolding and collapse of the formal State of Indiana-IBM contract and consider how the neglect of relational elements contributed to its premature demise. We have formulated the following theory-based propositions that we assess in our case analysis (described below):

- (1) The State of Indiana's strong hold over the rights of control, assets and authority for handling noncontracted contingencies in the MSA reinforced the hierarchical and legal (vs. relational) nature of the PPP and constrained cooperation;
- (2) The State reserved the right to replace subcontractors for performance concerns and created a quandary of "multiple principals" competing non-cooperatively to achieve the MSA goals;
- (3) With many fixed terms, clauses, schedules, and boilerplate material, the MSA was rigid and less amenable to adjustments for noncontracted contingencies over time;
- (4) MSA provisions consistent with fair trade were offset by contract provisions that undermined the relational norms of reciprocity and fairness.
- (5) The contracting parties expectations about how the agreement should change or what was an acceptable outcome (based on their subjective reference points and perceptions of fairness) did not align, and cooperation was replaced with reactive and punitive behavior;
- (6) A lack of trust between contracting parties taxed the formal and informal relationships, contributing to political maneuvering and hidden agendas, disengagement, and ultimately collapse of the PPP.

RESEARCH APPROACH AND ADDITIONAL BACKGROUND ON THE STATE OF INDIANA-IBM CASE

Research Methods

We employ a case study approach to our analysis to allow for the investigation of “a contemporary phenomenon within its real-life context” (Yin, 2003, p. 13), particularly given the call by theorists to refine the theory of formal relational contracting and identify essential conditions of this new model through its application to different settings (Fehr, Hart & Zehnder, 2009; Frydlinger and Hart, 2021). A constructive case analysis should illuminate, confirm, disconfirm or advance theory (Eisenhardt, 1989, 1991; Gerring, 2004; Yin, 2009). We see the State of Indiana-IBM case as especially fitting for application of the theories discussed above. Extensive agency and court documents and newspaper accounts—spanning approximately 15 years, i.e., including a decade after the PPP dissolved—substantiate that there was more to the failure of the PPP than a flawed idea about welfare modernization or a poorly designed formal contract. Publicly available documents illuminate a range of actors with divergent interests who had very different expectations and ideas about fairness in the PPP and the outcomes. And precisely because complex contracts such as the State of Indiana-IBM MSA are incomplete, they provide room for ex-post interpretation of the decision making with respect to the parties’ formal obligations and to their behavioral choices that go beyond the clauses and provisions specified in formal contract.

In this case study, we have the opportunity to trace the PPP and MSA (and individual and organization behavior) from beginning to end (Pentland, 1999). The data informing our research include relevant public documents and reports from 2005 (a year before the MSA was signed) through 2010 (a year after the contract was prematurely terminated); 33 interviews with key informants that took place in 2009 and 2010; court filings, depositions and other internal

correspondence dated from 2008 through 2013; and court rulings and news accounts through the end of 2020. A detailed summary of the case study data appears in Table 1.

[Insert Table 1 here]

In addition, one of the authors of this research (Heinrich) provided expert testimony in the State of Indiana vs. IBM court case in 2011—on the subject of contractual relationships between public sector and private sector entities and the development, implementation and effectiveness of performance management systems—and was deposed in the case. In preparing for this role, Heinrich reviewed all of the material’s on the State of Indiana’s FTP site (approximately 1,290 emails and 40 media articles and press releases) and another 677 case documents not provided by the State, including detailed contract information, change order forms, performance data, testimony, and other public and private communications.

In developing a list of possible interviewees for this study, we aimed to obtain a wide range of perspectives from key informants about how and why the contract unfolded as it did, what contributed to the contract collapse, and whether its failure could have been avoided. We also sought a deeper understanding of events beyond what was revealed in the court documents. We constructed an initial sample frame from a list of individuals named in court documents and newspaper accounts who purportedly had first-hand knowledge of events. The sampling approach employed a combination of purposive and snowball methods, as initial the interviewees provided recommendations for additional contacts (Biernacki & Waldorf, 1981). The final list of interviews conducted includes nine (9) management-level government employees, from the Family Social Services Administration or the Governor’s Office, thirteen (13) project -level employees, some of whom were transferred from government payroll to a contractor’s payroll, and ten (10) management-level employees from contractor or sub-contractor organizations.

We followed established protocols for conducting interviews to yield high-quality responses (De Leeuw, E. Hox, J.J. & Dillman, 2008). Given the political context of the project and respondents' possible hesitancy to answer questions openly and honestly, we preserved the anonymity of the interviewees. Interviews were conducted face-to face using open-ended questions, with follow-up questions to probe details. The interview questions are presented in Table 2.

[Insert Table 2 here]

Many face-to face interviews included follow-up phone calls as well. Interview responses that identified events as having occurred on a particular date were checked against document dates to verify accuracy, and we also compared the express contract terms with the parties' subjective views of the contractual arrangements and events in the analysis.

We integrated information collected in the interviews with the extensive public documentation, court records, and other sources of data described above in conducting the case analysis. We employed a process of "systematic examination of diagnostic evidence selected and analyzed in light of research questions and hypotheses posed by the investigator" (Collier, 2011, p. 823), with the goal of constructing a narrative of the case events and evaluating them in relation to our theory-informed research propositions about the implementation and unraveling of the State of Indiana-IBM PPP.

Additional Case Background

When Governor Daniels took office in 2005, Indiana's welfare system was "plagued by high error rates, fraud, wasted dollars, or conditions for employees, and poor service to clients" (Marion County Superior Court, Findings of Fact 2012, 3). The RFI written to solicit proposals identified an error rate of approximately 35% on standard long-term nursing home care

determinations that cost the State as much as \$50 million per year, excess Food Stamps payments totaling \$33.9 million, and a TANF application error rate of 25%. FSSA Secretary Mitch Roob described “huge backlogs, full voice mailboxes, overflowing file cabinets and a workflow process that was simply unmanageable” (3-13-08 letter to Undersecretary Johner, IBM D.E. 27). Indiana citizens seeking public assistance went to one of the state’s 107 local county welfare offices to apply and meet with caseworkers, but 48% of FSSA clients reported it was difficult to reach a caseworker (Eligibility Modernization, FSSA1_08279441). An Interagency Review Committee determined that FSSA and the State lacked the “internal expertise necessary to develop, implement and maintain a successful modernized Information Intake Process on their own,” and that the financial, technological and managerial resources necessary to make internal modernization successful would likely drain vital resources from other FSSA programs (Inter-Agency Review Committee Report, November 22, 2006, p. 13). Governor Daniels and his team accordingly set out to “transform and modernize” the process by which information needed or related to making eligibility determinations was collected, organized, and managed, with the belief that the private sector was best positioned to solve the problems (Goldsmith and Burke 2009, 99-100).

The Hoosier Coalition rolled out the modernization project in three stages to 59 Indiana counties. Phase 1 of the project was rolled out in March of 2007. Phase 2 was rolled out over seven months beginning in October of the same year, initiating a 12-county pilot representing about ten percent of the state’s caseload. The record shows complaints, high error rates and backlogs continuing in these early phases, with many call center phone calls left answered. Nonetheless, the state gave its authorization to move forward with the modernization plan, and

the Coalition rolled out the changes to an additional 27 counties in March 2008, and then to 20 more counties in May of 2008 when the State gave the go ahead again.

Concurrently, Indiana also introduced the Healthy Indiana Program (HIP), a new social program that further increased the volume of public assistance applications. Moreover, two external events exacerbated the backlogs and complaints. The onset of the Great Recession was felt in Indiana starting in 2007, and a series of storms and floods followed in 2008. FSSA Secretary Mitch Roob acknowledged the deleterious impact of these events on the Coalition's work, and in a 6/13/08 message, Division of Family Resources Director Zach Main complemented the Coalition's leadership and staff on their success in dealing with "far more applications during the initial few months" of Healthy Indiana than were expected and in responding to the extra demands for services from victims of flood and wind disasters. In August 2008, the parties agreed to reconvene and postpone additional rollouts. The IMB Global Services Team conducted an extensive, end-to-end performance assessment over a period of 12 weeks to evaluate all aspects of the eligibility modernization project and develop recommendations for program enhancements; the assessment found that any problems arising as a result of these circumstances were "eminently fixable" (End-to-end assessment at 3).

In November 2008, Governor Daniels was re-elected to office, and Secretary Roob proposed systemic changes to alleviate some of the problems. At the request of the FSSA, IBM submitted a corrective action plan (CAP) to the State, which went into effect on July 1, 2009, but explicitly did not "relieve either party of its duty to comply with the terms of the Master Services Agreement" (July 2, 2009, Exhibit 5407). Case evidence, discussed below, suggests the parties attempted to address challenges and to adjust to changing circumstances as the project went forward. As Table 3 shows, the initial MSA was amended four times between January 2008 and

April 2009. Ultimately, however, the CAP laid the groundwork for termination of the contract with IBM, and indeed, in August 2009 the state announced that it was terminating the agreement for cause.

[Insert Table 3 here]

CASE ANALYSIS

Shortcomings of the Formal Contract

We propose (1) that the State of Indiana's tight hold over the rights of control in its contractual relationship with IBM, including over the assets and authority for handling non-contracted contingencies in the MSA, reinforced a hierarchical and legal orientation in the relationship and constrained cooperation in the PPP. In particular, the State of Indiana retained all policymaking authority over the project and final authority with respect to eligibility determinations under each of the programs (MSA, sec 3.1.1(1)): "The State shall make and shall retain final authority with respect to any policy changes with respect to the Services as may be necessary to comply with applicable Law or which the State in its discretion determines to be appropriate and in the best interests of the State and its citizens." The contract specified other rights reserved by the State as well (§3.10), and importantly, the MSA provided the State the right to terminate the agreement for cause if there was a breach or series of breaches "material considering the agreement as a whole" (MSA sec 16.3.1 91) (A)-(C)).

The State's broad authority in the formal contract also extended to day-to-day operational aspects of the Coalition's work, including vendor service locations and standards of practice and the staffing of county offices. As FSSA Secretary Mitch Roob explained in a 3-13-08 letter to the Under Secretary of Agriculture for Food, Nutrition, and Consumer Services (of the U.S. Department of Agriculture), county welfare offices remained open and staffed with "real state

employees.” Nearly all of the state employees who were eligible to be transferred took jobs with the Hoosier Coalition, ensuring that the experience of state employees was also diffused into the new operating structures. In fact, in responding to criticism from the unions over the “privatization” of public assistance, Roob pointed out that 1,400 public employees (99.3% of those eligible) took jobs with IBM and/or its subcontractors (July 29, 2007 email to Dennis Ryerson, FSSA1_07392708). Moreover, numerous core functions—from project management to business operations to applications services, quality assurance, integrated technology, program operations and more—involved units and personnel from both the State and IBM/Coalition team partners (IBM-IN04133152-65; IBM-IN00828779-81, IBM-IN087864-69; FSSA1_07357871-2; FSSA1_06799643-4). The governance plan for the project also established an oversight structure that kept the State informed about, and involved in, key decisions on the project.

In addition, the State of Indiana approved the program structures and subcontractors that were put in place by IBM and hired experts to monitor the contractors and their performance. As seen in Figure 1, IBM subcontracted with at least eight other vendors to carry out the work of the contract. The MSA made clear that IBM would be the sole point of contact for contractual matters; it also specified that the State had no obligation (financial or other) to any subcontractor, and that IBM would be fully responsible for obligations, services and functions performed by the subcontractors (MSA, Schedule 14). Even so, IBM was required to provide evidence to the State of the subcontractors’ ability to perform the subcontracted functions, and the State reserved the right to replace subcontractors for performance concerns. IBM was also required to include mandatory subcontract provisions (contained in Schedule 15 of the MSA) with no modifications or alterations unless determined acceptable by the State. In effect, the State retained tight control

and oversight of IBM even in the areas where the MSA appeared to cede authority to the Vendor in executing the work of modernizing Indiana’s public assistance system.

We correspondingly propose (2) that the State’s retention of the right to replace subcontractors for performance concerns created a potential contractual quandary of “multiple principals”—with subcontractors beholden to the performance expectations of both the State and IBM—who failed to sustain a cooperative relationship and goal alignment in the PPP (Dixit, 2002). The MSA explicitly recognized the interdependencies of the various parties in executing the project work; for example, it expressly addressed the need for State cooperation in the Transition Plan (§ 3.2.3) and for the parties’ cooperation with the federal government, legal staff and investigators (§ 3.9.3), and it granted the Vendor access to and use of state resources (§ 3.2.8), assets, and records (§ 3.4.9). The MSA also stipulated a communication plan (§ 3.2.6) that specified frequent meetings (§ 3.1.2), with the expectation that the subcontractors would communicate through IBM, the primary Vendor, as depicted in Figure 1. In practice, however, this formal chain of command was not followed, contributing to the multiple principals problem. Court documents and internal correspondence show that while the primary vendor, IBM, communicated directly with the FSSA and the Governor’s Office, ACS Human Services (ACS, a subcontractor of IBM) circumvented IBM and communicated directly with the FSSA and the Governor’s Office. In addition, many of the subcontractors communicated directly with ACS. ACS had been closely involved with the State in operating its social services eligibility systems prior to the establishment of the MSA and Hoosier Coalition, and a fallout between ACS and IBM (complicated by ACS’ prior relationship with the State) later resulted in countersuits between IBM and ACS (Indiana Court of Appeals, No. 49A02-1301-PL-49).

More generally, as the principals' (the State and IBM's) interests diverged, the more heightened the collective action problems became (as predicted by theory), resulting in greater inefficiencies and welfare loss (Estache and Martimort, 1999; Young, 2002; Su et al., 2007; Vroon et al., 2018). In this case, competing interests were illuminated in court transcripts and in interviews with key actors. Multiple interviewees considered ACS, the main subcontractor to IBM, to be uncooperative. According to one interviewee, "ACS was never on board ...", consistent with research showing that agents (subcontractors in this case) gain autonomy when the interests of multiple principals conflict (Miller, 2005). Pointing to this very problem, another interviewee lamented that ACS "ignored the agreement [and] did not have to answer to anybody." Public documents and commentary also suggested that the State strategically alternated between stressing its central role and tight control of the modernization project and distancing itself from and singling out IBM in the case of reported difficulties or challenges in implementation. For example, referring to their joint efforts, Zach Main (FSSA Director of the Division of Family Resources), stated on August 25, 2008 (FSSA1_04551061): "We know we face some significant challenges as we implement this new system, but we put together the right team to fix it." In contrast, a year later when the Hoosier Coalition was on the verge of collapse, the Governor of Indiana attempted in a September 18, 2009 communication to distance the State from the project: "You need to understand that 94% of FSSA is private contracts. Almost all of FSSA—Medicaid, other aspects of social service, is done through contracts."

Information from interviews and public documents also suggest that the subcontractor ACS did not cooperate because it was perceived that the performance standards only applied to IBM, and thus, according to one interviewee, "ACS was not [actually] violating policy." Despite the organizational interdependencies acknowledged in the MSA, the performance standards in

the agreement focused solely on the primary vendor, IBM, and did not include penalties to dissuade other parties in the coalition from noncooperative behavior or free-riding. Schedule 10 of the MSA articulated four categories of performance standards that were tied to financial penalties for IBM: Service Levels, focused on process accuracy and error rates in program administration; Key Performance Indicators related to service components; Critical Transition Milestones related to the public to private transition of services; and Federal Penalties, imposed by the federal government for failing to meet the federal minimum work participation rates. In fact, a close review of the 17-page Schedule 10 suggests a performance-based contract focused almost entirely on process measures associated with core functions for which the State and IBM shared responsibility—procedure variance rates, office staffing hours and availability, call response and hold times, document barcodes, scanning resolution, timeliness of procedures, and implementation milestones for the transition—with family work participation rates the lone output-oriented performance measure. Schedule 15 of the MSA further specified “remedies” for performance deficiencies of the contracted parties, including non-payment, liquidated damages, and corrective action plans. Although the task complexities and PPP interdependencies diminished the ability of the State to attribute success or substandard performance to any one party, email communications within the FSSA in August of 2009 suggested that IBM would be singularly thrown “under the bus,” with the State dropping “bombs ala Hiroshima and Nagasaki” (FSSA1_08398771, IBM D.E. 88) as the PPP collapsed. This outcome is consistent with many of the accountability-related concerns of multiple principals identified by Schillemans and Bovens (2015): higher transaction costs, conflicting expectations, accountability confusion, negativism, loss of control, blame games, and symbolic accountability.

With many fixed terms, clauses, schedules and boilerplate material, we propose that the rigid MSA was less amenable to adjustments (3) as cooperation among the parties waned and new noncontracted contingencies arose over time. Contracts that are rigid (like the MSA) contain many fixed terms, typically aimed at constraining opportunistic behavior. A flexible contract, on the other hand, provides room for adjustment as circumstances change. While research on formal contracts suggests that parties should strive to strike a balance between rigidity and flexibility, the evidence in this case implies that this did not happen. In the Final Order of The Superior Court, Judge Dryer recognized that sophisticated lawyers for both parties were involved in negotiating and drafting the MSA, and that they anticipated the many challenges ahead and sought to leave room to fill in some of the details at a later date (Dryer, 2012, p. 15). However, in practice, the tradeoff between rigidity and flexibility is not easily achieved, especially when one of the parties is a government agency that is required to adhere to strict guidelines in drafting contract language. The MSA is effectively an expanded version of the template (designed for two parties) that is contained in the *Indiana Manual for Professional Services* and supplied to state agencies by the Indiana Department of Administration (IDOA). The IDOA requires agencies to include many fixed terms or “boilerplate clauses.” Examples include a “termination for convenience” clause, a “non-collusion statement,” a “drug free certification,” and a certification that the Vendor has “no investment in Iran.” In fact, agency officials who draft these contracts are responsible for certifying that all boilerplate provisions are included in the contracts, regardless of the extent to which these added rules and regulations constrict the contracting relationships and the malleability of the PPP.²

² This certification is included on page 25 of the 2013 IDOA Contract Manual for Professional Services: THE FOLLOWING PARAGRAPHS 4 THROUGH 49 ARE DEFINED BY IDOA AS STATE BOILERPLATE CLAUSES. STATE BOILERPLATE CLAUSES SHALL REMAIN UNALTERED AND IN THEIR STANDARD

As both theory and evidence submit, all contingencies cannot be anticipated *ex ante*, and incomplete contracts are the norm (Hart, 1998; Heinrich & Choi, 2007). The parties to the MSA did not anticipate the substantial increase in public assistance applications or the added claims on resources and delays in meeting them caused by major storms or the Great Recession that hit Indiana after the contract was signed. At the same time, substantive changes detailed in subsequent amendments to the MSA suggest that some fundamental elements of the arrangements were not in order or not finalized before the contract was enacted. As a result, the parties were regularly negotiating change orders and amendments as the relationship unfolded. In 2008, more than a year after the initial MSA was signed, the parties were still negotiating leases for Vendor service locations, employees were still being relocated and transitioned from government payrolls to subcontractors, and draft procedure manuals were still being developed. This constant flow of change orders—and the additional transaction costs incurred—were not evidence of flexibility in the contracting relationship, but rather of a continued focus on transactional details and procedural minutiae in the formal contract that reinforced the rigid nature of MSA and further diminished opportunities to develop relational aspects of the PPP.

Limitations Reflecting the Lack of Relational Governance

We propose (4) that MSA provisions consistent with fair trade were offset by contract provisions that undermined the relational norms of reciprocity and fairness. The MSA parties' intention to engage in fair trade was signaled in multiple contract provisions. For example, the parties agreed to a contract term of ten years and a renewal option, presumably providing adequate time to recoup specialized investments. The MSA also provided that the State pay IBM

FORM, UNLESS ANY CHANGES OR ALTERATIONS ARE DOCUMENTED AS REQUIRED UNDER PARAGRAPH 46, "BOILERPLATE AFFIRMATION CLAUSE".

“early termination close out payments,” including reimbursement for hardware and software costs, certain salary and labor costs, and costs for leasehold improvements (MSA, §16.6.6 (3)-(4)). These contract clauses imply an intent for fairness in the exchange, an important foundation for trust and reciprocity. However, the MSA also included many provisions that suggested the State was not in the relationship for the duration. Not only were these provisions inconsistent with other parts of the same contract document, they undermined relational norms that are essential for successful relationships. For example, a termination for convenience clause allowed the State to end the contract without a showing of fault. Also, the State retained the option to step into IBM's shoes as the prime contractor if it determined that ending the relationship early was in its best interest (MSA, § 16.3.2). The State also retained the option to assume IBM's subcontractors, with some conditions (MSA, § 14.8.1(3)). Finally, the State had the option to purchase the computer and other dedicated equipment that IBM supplied for the modernization project (MSA, §16.6.6 (1), (3)). The inclusion of these clauses suggests that the State may have contemplated ending the schedule ahead of time.

Frydinger et al. (2021: 227-28) specifically address termination for convenience clauses and suggest ways they can be adjusted to reinforce relational norms without compromise to accountability. For example, using a lens of transparency and applying the loyalty principle, the parties could reveal the circumstances that would make it more costly to remain in the contract than to terminate it. Applying the principle of reciprocity, a termination clause should be bilateral, clearly spelling out the justified conditions for early termination by either side. Applying the principle of equity, a termination clause should allow the supplier to recoup any asset specific investments for which it had not yet received a full return on investment. The advantage to

adjusting the contracting language to reflect relational norms is that “both parties align on more realistic expectations, which ultimately reduce shading after the contract is signed” (p. 228).

We propose (5) that, to the detriment of the contract’s viability, the contracting parties had different expectations about how the agreement should change or what was an acceptable outcome (based on their subjective reference points and perceptions of fairness). Frydlinger and Hart (2010) put forward the idea of contracts-as-reference-points to explain why parties may judge an initial contract as fair, but later, after the contract is signed, view the same contract very differently, that is, as unfair. This perspective starts with the premise that contracts are always incomplete. Consequently, when unforeseen circumstances arise, the parties are presented with the opportunity to reinterpret their obligations. Because interpretations are influenced by self-serving biases, each side interprets the contract in a way that is most favorable to them.

In the Indiana case, there is clear evidence that the parties could not have anticipated the economic recession or the major storms that affected the PPP work and substantially increased the number of applicants in need of social services. The initial MSA, dated December 2006, was amended four times; the first major amendment was signed in January 2008, and the fourth amendment was signed in April 2009. Each amendment involved lengthy negotiations, and in the end, each party signed off in agreement. Presumably, each amendment reflects a meeting of the minds as to what changes were necessary to move the project forward. Still, there is ample evidence that the parties had different interpretations regarding how the changed circumstances affected their respective obligations. In proceeding before the Indiana Superior Court, the State argued that IBM breached the contract by not meeting performance requirements. In rebuttal, IBM argued, in part, that it should not be penalized for circumstances beyond its control. As the contract relationship unfolded, the parties also disagreed on what tasks fell within the scope of

work described in the original MSA. The State took the position that some tasks were contemplated in the original MSA and therefore not billable as extra costs, whereas IBM disagreed. In fact, the different interpretations about what was billable and what was not billable may have been a key reason for the eventual breakdown of the relationship. According to Judge Dryer's Final Order, when FSSA officials decided to abandon the idea of an entirely remote system and to adopt a hybrid system (September 2009), State officials offered to continue to work with IBM under the new model, but IBM officials decided they would only do so if they received additional compensation (Order, page 35). Shortly thereafter, the State announced it was terminating the contract.

From a contract-as-reference-point perspective, parties will use a reference point to interpret their obligations even when the contract language is clear and absolute. There is an abundance of literature that documents this way of thinking, including empirical evidence from the lab and field. For example, Homans (1974) observed, those individuals who have less of something generally place a higher value on each unit they possess, and each marginal unit obtained. The Loss Aversion Model by Kahneman and Tversky (1979) and Tversky and Kahneman (1991) shows that an individual's evaluation of economic outcomes is not based on an absolute valuation but depends heavily on their desire to avoid losses relative to a reference point. Applying the reference point concept to the Indiana case, the perception of fair or unfair treatment would depend on whether or not one perceived the extra billing as an entitlement.

The self-interest bias, which affects one's reference point, also affects behavior. That is, when parties do not receive the treatment they expect, they feel aggrieved and *shade* by performing in a perfunctory rather than a consummate fashion (Hart and Moore 2008). Shading can take many forms, noncooperation being just one form, and may occur at various levels in

unexpected situations (Frydinger et al, 2021). This has important implications for incomplete contracts, the State of Indiana-IBM MSA being a prime example. Specifically, in an incomplete contract, it follows that the parties have not communicated their expectations as to how the deal will change when circumstances change, which opens the window for self-serving bias and shading. One of the witnesses who testified before the Indiana Superior Court portrayed behavior consistent with this theory: The witness described ACS's Richard Rhoad, who was placed in charge of the corrective action plan (CAP) as “uncommitted”. The same witness testified that Rhoad was nominally an ACS employee but maintained his office at the State with Anne Murphy's executive team and spent his time “going behind IBM's back to try to get IBM terminated.” In addition, the email exchange referenced earlier between FSSA Secretary Anne Murphy and the FSSA Director of Communications—where the Communications Director alludes to throwing IBM under the bus and dropping bombs on them—is another clear example of punitive behavior.

Finally, *we propose (6) that the lack of trust between the contracting parties taxed both the formal and informal relationships, contributing to political maneuvering and hidden agendas.* The contracts-as-reference-points perspective also illuminates some reasons for the non-cooperative behavior observed in the State of Indiana-IBM case. When a party perceives the deal is falling short of their reference point, which in this case, was based on their perception of fairness and what tasks were within the original scope of work, the party will no longer be proactive in the contract relationship or will stop cooperating. As contract performance declines, attribution may also play a role, if one party perceives the other party as being responsible for the outcome or perceives that the other party did not do all it could to ameliorate the situation.

Up to a point, as the work of the PPP unfolded, the parties made adjustments to the initial MSA. The parties worked through unanticipated contingencies not covered in the initial contract and continued to make investments and change orders; contract amendments were frequently agreed upon. On the surface, this behavior appeared consistent with a level of trust among the partners, where as described by Helper and Levine (1992), the parties “are confident that if they lose a little bit (compared to their expectations) they will come out ahead next time” (p. 563). Indeed, trust, as a state of mind, is part of a relational contract, or unwritten codes of conduct that are self-enforcing (Telser, 1981).

The exact turning point in the relationship is debatable, but there came a time when cooperation ceased, and even small concessions were no longer an option. Several interviewees with key roles in the project anticipated the end of the MSA before the official announcement.³ At least four interviewees saw management changes at the FSSA as a signal of the end of cooperation, when FSSA Secretary Roob moved on to another government post and the new head of FSSA, Anne Murphy, stepped into the position. In fact, a July 2, 2009 internal email from Secretary Murphy, appeared to make this clear: “As we gear up for a potential breach of contract action against IBM/Coalition, we have asked OVV to really ‘audit’ performance on timeliness, accurateness, etc. I put audit in quotes because I doubt it technically falls within the definition of audit, but what I do know is that we’ve stretched the OVV vendor thin and they need some assistance in monitoring and documenting... All personnel working on the eligibility modernization are potential witnesses in court for a breach of contract case, so you’ll want to

³ Interview Question” “Thinking about the project from the beginning in January 2007 to when it ended in September 2009, what events do you recall as most significant? These can be major milestones, a change in policy or personnel, or whatever comes to mind..... Approximately when did this occur?”

keep that in mind as you are thinking about who could be deployed.” (PRIV-FSSA-00009589) Here, Secretary Murphy appears to be looking for ways to use performance auditing to create evidence that will support the intent to end the contract. Performance monitoring that becomes increasingly antagonistic and intrusive over time, as it did in this PPP, breaks the cords of trust and cooperation that are essential in a longer-term contractual relationship. Goldsmith and Eggers (2004, 121) described this phenomenon aptly, where “an overreliance on box checking and rule compliance”—in which government focuses on “finding wrongdoing instead of making the partnership work—leads to an adversarial relationship with partners.”

Responses from other interviewees suggested an accumulation of problems led to the breakup, noting for instance the many change orders and the escalation in costs or the evolving “chain of command.” Others opined on the many project interruptions caused by the massive storm that hit Indiana or the introduction of new social program policies, such as the Healthy Indiana Program. Governor Daniels himself stated: “one of the reasons for the problem[s] is that the recession came and the demand on the system was suddenly much bigger than anyone had ever seen,” 12/23/09 transcript, Amos AM1310 (FSSA1_07479109). Another interviewee suggested the Governor’s re-election was the beginning of the end of the PPP. Yet even as he was announcing his decision to terminate the contract in a press conference, Governor Daniels stated that IBM should be “commended” for its performance, noting a series of benefits the state received from the project, including a paperless system, reduction in fraud, improvement in welfare to work statistics, and significant cost savings (10/15/09 transcript, IBM D.E. 345).

The court documents and interview data reveal multiple conflicts related to the roles of the various parties, some of which implicate varying perceptions of fairness. One main point of contention was the designation of IBM as the primary contractor. During contract negotiations,

there was considerable discussion about whether IBM or ACS should be the primary contractor. Although ACS had prior relationship with the state, the decision was made to designate IBM as the primary and ACS as a subcontractor of IBM. The fact that numerous observers described ACS as uncommitted, noncooperative, and circumventing the chain of command appears to support the idea that ACS did not accept this decision. Even though the MSA required all communication to go through IBM, a point which ACS understood, ACS made a habit of contacting the Governor's office and FSSA directly. State employees did not comply with this requirement either and expressed dissatisfaction when they were called out on the matter.

We would expect the non-compliance of ACS and the State to have further diminished the trust relationship between IBM and the State. It may also have compromised any trust relationship among other members of the coalition as they observed the behavior. Supervisors and managers in the workplace strongly influence whether trust develops in the first place. As Rousseau (1995, Chap. 3) observes, managers function as "contract makers" and as such have substantial influence on the formation of relational contracts. Also, one's perceptions of justice is affected by one's place in the organization (Schminke et al., 2002). For their part, ACS apparently thought they were performing work that should have been done by IBM and also picking up the cost of that work. On several occasions, ACS complained about the compensation that IBM was receiving.

Superior Court documents and press releases tell the official story from the Office of the Governor. In September 2009, FSSA officials decided to abandon the idea of an entirely remote system and to adopt a hybrid system, called Plan B, that allowed for some face-to-face contact between applicants and caseworkers. As indicated above, the 12-week long, end-to-end performance assessment of the modernization project found that the problems were remediable

and provided a foundation for the State and Coalition to move forward with improvements (End-to-end assessment at 3). In fact, apparently having recognized the value IBM brought to the project, court transcripts confirm that state officials offered to continue to work with IBM under the new model and wanted IBM to implement the Plan B concept. However, the State would not agree to pay IBM additional sums to implement the changes, ostensibly due to a lack of budgeted funds, and IBM declined to move forward with the project under these terms (IBM D.E. 135, September 27, 2009 email from Anne Murphy to FSSA colleagues). Shortly thereafter, the State announced it was terminating the contract.

CONCLUSION

Our case analysis, assessing six propositions about the implementation and unraveling of the State of Indiana-IBM MSA, suggests that a formal relational contract may have better served this complex, multi-actor Hoosier Coalition PPP. Among the arguments for replacing a transactional contract with a formal relational contract, we see the following as relevant to this case: (1) the effectiveness of a formal conventional contract rests in part on its clarity in allocation of authority and responsibilities and its allowance for flexibility in addressing future changes in the state of the world; (2) even if well-specified, a conventional formal contract cannot address all contingencies; (3) changes in the state of the world open the door for interpretation, in which case self-serving biases can lead to subjective views on entitlements and differing perceptions of fairness; and (4) formal relational contracts are better suited for maintaining alignment if they are crafted using guiding principles based on social and relational norms that are enforceable by third parties. Our analysis of this case provided evidence consistent with each of these arguments.

The formal agreement (MSA) was too rigid and prescriptive a guide for parties undertaking such a complex, novel project. If rigid terms were intended to constrain parties' behavior, they did not work in this PPP. During the project, the contracted parties were in a constant state of renegotiation, yet their failure to cultivate a trusting relationship alongside the MSA suggests that in drafting the agreement, they missed the mark in striking the right balance between rigidity and flexibility. In fact, the formal relationships degraded to the extent that the State and IBM sued each other for behavior they perceived as contract violations, and IBM also sued ACS for contract violations.

In addition, the MSA specified a clear chain of command that was either intentionally not followed or was difficult to follow given the complexities of the project and various tasks and organizational interdependencies. Specifically, the MSA provided the State with final authority over major decisions and IBM (the primary vendor), as well as authority over all subcontractors. However, the record shows that the major subcontractor, ACS, had unfettered access to both the Governor's office and the Director of the FSSA. The consequences of this particular aspect of the contractual relationship are hard to overstate. The violation of the chain of command occurred very early in the contract, which undoubtedly further constrained the cultivation of trust among the PPP parties going forward. Court testimony and responses from interviewees illuminated perceptions of distrust, disloyalty, and an unfair dealing that followed. Indeed, it is clear from interview responses that many involved in the project perceived the practice of circumventing the chain of command as unfair and the behavior of ACS as uncooperative.

Lessons for Future Contracting in Complex PPPs

Like many government contracts, the State of Indiana-IBM MSA included numerous boilerplate provisions that undermined social norms of reciprocity and fairness. The termination

for convenience clause is just one example. In entering into a long-term partnership, especially one that involves asset specific investments, the parties need to feel some level of confidence that the deal will not be terminated at a whim. They need assurances that, at a minimum, they will be able to recoup their investment. Having confidence that the contracting parties will be dealt a fair hand engenders trust, which is a foundation for sustaining relationships, especially through challenging circumstances as were encountered in Indiana over this period. A termination for convenience clause has the very opposite effect; signaling a party may pull out of the deal at its discretion and without cause or explanation (Frydinger et al. 2021, p. 228). Any basis for the clause that rests on accountability appears to be outweighed by its negative effects on the parties' relationship and the contract outcome. To address this problem, termination for convenience clauses can be replaced with clauses specifying reasons or circumstances for ending the contract that are perceived as fair and justifiable by all parties.

Another issue with formal contracts that is applicable to multi-party PPPs and was glaring in the case at hand concerns the fact that the contract was signed by only two parties, yet the project called for the cooperation of a network of partners. Like most complex projects, the Indiana Welfare Modernization Project involved a network of parties and nested relationships among contractors, subcontractors and government workers. Any level of cooperation between the two contract signatories, FSSA and IBM, may not have been sufficient to sustain the relationship. Parties are motivated to cooperate as long as the value for cooperation is higher than the value for defection. Cooperation is also a function of the overall payoff structure, which should apply to all of the parties in the collaboration. In the Hoosier Coalition PPP, the performance of the primary contractor, IBM, depended on the cooperation of several other parties—primarily ACS. ACS, however, conducted itself not only as a collaborative partner in

the project, but also as a potential competitor. Case evidence suggests that ACS lobbied the Governor's office throughout the life of the contract and may have had some motivation to undermine the contract and to become the primary partner. According to court testimony and interviews, ACS simply did not believe it had to cooperate because it did not sign the MSA. Research has long recognized that there may be better models—i.e., new governance and network arrangements—that could replace the older, traditional two-party contracts in PPPs. For example, hierarchical, multiparty contractual arrangements can be replaced by documents or other institutional mechanisms that bind multiple parties and yet are more likely to foster relational governance elements. In the case at hand, guidelines that prohibited the lobbying of executive agencies and other government officials under specific conditions may have prevented some of the uncooperative, counter-productive behavior we observed.

The formal relational contract aims to solve the incomplete contracting problem by incorporating relational norms into the legally-binding contractual agreement. Parties use guiding principles based on social norms to articulate a path forward when circumstances change. The principles not only clarify expectations, they yield a template of sorts for future behavior, where the end result is a living contract document that serves to keep parties aligned and is enforceable by a third-party. In essence, the decision making shifts from the traditional make or buy decision—i.e., produce in-house or outsource—to one where contract choices are ongoing and made in the context of a cooperative and flexible governing arrangement.

Insights from theory and case evidence also suggest that in choosing to structure a PPP as a formal relational vs. a transactional contract, the parties should pay careful attention at the outset to the potential for misalignment of the interests and goals of the parties (Frydlinger et al., 2021, pp. 111). In the Hoosier Coalition case, some of the factors that contributed to the potential

for misalignment included: a very high economic value of the contract (exceeding \$1 billion dollars); the contract's strategic importance to a range of stakeholders, including a vulnerable population in need of social services, citizens, taxpayers, politicians, and multiple organizations; the steep costs of failure or weak performance for the stakeholders; the novelty and complexity of the PPP work and relationships for executing it; the many uncertainties that could disrupt the work plans, e.g., natural disasters, labor uncertainties, policy shifts, and technical difficulties, to name a few; and the anticipated long tenure of the agreement (i.e., 10 years). As Frydlinger et al. (2021, p. 108) explain: "The overall logic is simple: the higher the dependency and risk, the more critical it is to apply a relational contract design to continuously align the interests and expectations of the parties." As government agencies at all levels will continue to rely on complex, multi-actor contracts in PPPs like the one we studied here, they should be encouraged to consider developing formal relational contracts—entailing the specification of mutual goals and governance structures and the cultivation of trust and cooperation—alongside legally enforceable contracts to provide the foundation for cooperation and the mechanisms through which the parties will work together to achieve the goals of the PPP.

At the same time, we recognize that there are limits to generalizability from a case study such as this, the first one we know of to explain how a formal relational contract may have prevented the unraveling of a complex PPP. It is also the first case study we know of to add to the theoretical and experimental research on reference points. While the evidence in this case study appears to support Hart and Moore's (2008) contracts as reference points theorizing, it also suggests that further research is needed to address important questions regarding the role of competition and communications in shading behavior, as well as more generally on the potential for formal relational contracts to improve public sector contracting and PPP success.

References

- Baker, G., Gibbons, R., & Murphy, K. J. (2002). Relational contracts and the theory of the firm. *The Quarterly Journal of Economics*, 117(1), 39-84.
- Bernheim, B.D. and Whinston, M.D. (1998). Incomplete contracts and strategic ambiguity. *American Economic Review*. 88(4): 902-32.
- Bertelli, A.M. & Smith, C.R. (2010). Relational contracting and network management. *Journal of Public Administration Research and Theory*, 20 (suppl_1), i21-140.
<https://doi.org/10.1093/jopart/mup033>
- Brosnan, S. F., & de Waal, F. B. M. (2014). Evolution of responses to (un) fairness. *Science*, 1251776. doi:10.1126/science.1251776
- Brown, T. L., & Potoski, M. (2003). Managing contract performance: A transaction cost approach. *Journal of Policy Analysis and Management*, 22(2), 275-297.
- Camerer, C. F., & Thaler, R. H. (1995). Anomalies: Ultimatums, dictators and manners. *Journal of Economic Perspectives*, 9(2), 209-219.
- Collier, D. (2011). Understanding process tracing. *Political Science & Politics*, 44(4), 823-830.
doi:10.1017/S1049096511001429
- Covey, S. M. R., & Merrill, R. R. (2006). *The Speed of Trust: The one thing that changes everything*. New York: Free Press.
- De Leeuw, E. D., Hox, J. J., & Dillman, D. A. (2008). Mixed-mode surveys: When and why. *International Handbook of Survey Methodology*, 299-316.
- Dixit, A., (2002). Incentives and Organizations in the Public Sector. *Journal of Human Resources*, 37, 696–727.

- Dryer, D. 2012. Final Order . July 18, 2012. In the Matter of Indiana Family & Social Services Administration, Planitiff v. International Business Machines Corportation, Defendant. In State of Indiana, County of Marion, Superior Court Civil Division 10, Cause No. 49D10-1005-PL-021451
- Eisenhardt, K. M. (1989). Building theories from case study research. *Academy of Management Review*, 14(4), 532-550.
- Engstrom, H, Alic, A. & Laurin, K. 2019. Chapter 3 in *New directions of research in fairness and legal authority*.
- Estache, A., & Martimort, D. (1999). Politics, transaction costs, and the design of regulatory institutions. *World Bank, Working Paper #2073*.
- Fehr, E., & Gächter, S. (2000). Fairness and retaliation: The economics of reciprocity. *Journal of Economic Perspectives*, 14(3), 159-181.
- Frydlinger, D., & Hart, O. D. (2019). *Overcoming contractual incompleteness: The role of guiding principles* . National Bureau of Economic Research, (No. w26245).
- Frydlinger, D., Hart, O., & Vitasek, K. (2019). A new approach to contracts: How to build better long-term strategic partnerships. *Harvard Business Review*, 97(5), 116-126.
- Frydlinger, D., Vitasek, K., Bergman, J., & Cummins, T. (2021). *Contracting in the New Economy: Using Relational Contracts to Boost Trust and Collaboration in Strategic Business Relationships*. Palgrave Macmillan.
- Gerring, J. (2004). What is a case study and what is it good for?. *American Political Science Review*, 98(2), 341-354.
- Gibbons, R. (2005). Four formal (izable) theories of the firm. *Journal of Economic Behavior & Organization*, 58(2), 200-245.

- Gibbons, R.S. and Henderson, R.M. (2012). Relational contracts and organizational capabilities (July 18, 2011). *Organization Science*, Vol. 23, No. 5, September–October 2012, pp. 1350–1364.
- Goldsmith, S., & Kettl, D. F. (Eds.). (2009). *Unlocking the power of networks: Keys to high-performance government*. Brookings Institution Press.
- Guercini, S., La Rocca, A., Runfola, A., & Snehota, I. (2014). Interaction behaviors in business relationships and heuristics: Issues for management and research agenda. *Industrial Marketing Management*, 43(6), 929-937.
- Hart, O., and J. Moore (1988). Incomplete Contracts and Renegotiation. *Econometrica* 56, pp. 755-786.
- Hart, O., & Moore, J. (2008). Contracts as reference points. *The Quarterly Journal of Economics*, 123(1), 1-48.
- Hart, O., A. Schleifer and R. W. Vishny (1997). The proper scope of government: Theory and an application to prisons, *The Quarterly Journal of Economics*, 112 (4), 1127-1161.
- Hart, O. & Holmström, B. (2016). The long and the short of contracts. Press release: The Prize in Economic Sciences. <https://www.nobelprize.org/prizes/economic-sciences/2016/press-release/>.
- Heinrich C.J. & Choi Y. (2007). Performance-Based Contracting in Social Welfare Programs. *The American Review of Public Administration*, 37(4):409-435.
doi:10.1177/0275074006297553
- Helper, S., & Levine, D. I. (1992). Long-term supplier relations and product-market structure. *Journal of Law, Economics & Organizations*. 8, 561.

International Business Machines Corporation (IBM, Appellant Cross-Appellee) v. State of Indiana (Appellee/Cross-Appellant. Amended Order. Supreme Court Case No. 19S-PL-19 Court of Appeals Case No. 49A02-1709-PL-2006 Trial Court Case No. 49D01-1005-PL-21451

Homans, G. C. (1974). *Social behavior: Its elementary forms*. New York: Harcourt, Brace & World

Kahneman, D., Knetsch, J. L., & Thaler, R. (1986). Fairness as a constraint on profit seeking: Entitlements in the market. *The American Economic Review*, 728-741.

Kahneman, D., & Tversky, A. (1979). Prospect theory: An analysis of decision under risk. *Econometrica*, 47(2), 263–292.

Kahneman, D., & Tversky, A. (2013). Prospect theory: An analysis of decision under risk. In *Handbook of the fundamentals of financial decision making: Part I*, 99-127).

Lin, C.-P., & Chuang, C.-M. (2011). Principal–principal conflicts and IPO pricing in an emerging economy. *Corporate Governance*, 19, 585– 600.

McAfee, R. P., & McMillan, J. (2019). *Incentives in government contracting*. University of Toronto Press.

Macaulay, S. (1963). Non-contractual relations in business: A preliminary study. In *Stewart Macaulay: Selected Works* (pp. 361-377). Springer, Cham.

Macneil, I. R. (1983). Values in contract: internal and external. *Nw. UL Rev.*, 78, 340.

Macneil, I. R. (1985). Relational contract: What we do and do not know. *Wis. L. Rev.*, 483.

Macneil, I. R., & Campbell, D. (2001). *The relational theory of contract: selected works of Ian Macneil*. Sweet & Maxwell.

- Miller, G. J. (2005). The political evolution of PA models. *Annual Review of Political Science*, 8, 203– 225.
- Ostrom, E. and Walker, J. (Editors. 2003.) *Trust and Reciprocity: Interdisciplinary Lessons for Experimental Research*. Sage Foundation Series on Trust, Volume 6. New York: The Russell Sage Foundation
- Oye, K. A. (1985). Explaining cooperation under anarchy: Hypotheses and strategies. *World Politics*, 38(1), 1-24.
- Romzek, Barbara S., and Patricia W. Ingraham 2000. Cross pressures of accountability: Initiative, command, and failure in the Ron Brown plane crash. *Public Administration Review*, 60 (3): 240–53.
- Rousseau, D. M. (1989). Psychological and implied contracts in organizations. *Employee Responsibilities and Rights Journal*, 2(2), 121-139.
- Ryall, M. D., & Sampson, R. (2009). Repeated interaction and contract structure: evidence from technology development contracts. *Management Science*, 55(6), 906-925.
- Salamon, L. (2001). The New Governance and the Tools of Public Action: An Introduction, *Fordham Urban Law Journal*, 28(5), 1611-1674.
- Schilke, O., & Lumineau, F. (2018). The double-edged effect of contracts on alliance performance. *Journal of Management*, 44(7), 2827-2858.
- Schillemans, T., & Bovens, M. A. P. (2015). The challenge of multiple accountability: Does redundancy lead to overload? In M. J. Dubnick & H. G. Frederickson (Eds.), *Accountable governance: Problems and promises* (pp. 3– 21). Armonk, NY: M. E. Sharpe.

- Schminke, M., Cropanzano, R., & Rupp, D. E. (2002). Organization structure and fairness perceptions: The moderating effects of organizational level. *Organizational Behavior and Human Decision Processes*, 89(1), 881-905.
- Sclar, E.D. (2000). *You don't always get what you pay for: The economics of privatization*. Ithaca, NY: Cornell Univ. Press.
- Speidel, R. E. (2000). Relational Contract Theory: Unanswered Question. *The Characteristics and Challenges of Relational Contracts*, 94.
- Su, Y., Xu, D., & Phan, P. H. (2007). Principal–principal conflict in the governance of the Chinese public corporation. *Management and Organization Review*, 4, 17– 38.
- Telser, L. G. (1980). A theory of self-enforcing agreements. *Journal of business*, 27-44.
- Thibault, J., & Walker, L. (1975). *Procedural justice: a social psychological analysis*. Hillsdale, NJ: Lawrence Elbaum Associates.
- Tyler, T. (1990), *Why people obey the law?* New Haven: Yale.
- U.S. General Accounting Office. (2002). Welfare reform: Interim report on potential ways to strengthen federal oversight of state and local contracting. GAO-02-245. Washington. DC: Author.
- Van Slyke, D.M. (2007). Agents or Stewards: Using Theory to Understand the Government-Nonprofit Social Service Contracting Relationship. *Journal of Public Administration Research and Theory*, 17(2): 157–187, <https://doi.org/10.1093/jopart/mul012>
- Voorn, B., Van Genugten, M., & Van Thiel, S. (2019). Multiple principals, multiple problems: Implications for effective governance and a research agenda for joint service delivery. *Public Administration*, 97(3), 671-685.

- Walker, L., LaTour, S., & Houlden, P. (1974). Procedural justice as fairness. *Stanford Law Review*, 26, 1271-1289.
- Williamson, O. E. (1981). The economics of organization: The transaction cost approach. *American Journal of Sociology*, 87(3), 548-577.
- Yin, R. K. (2003). *Design and methods. Case study research*, NY: Sage
- Yin, R. K. (2009). *Case study research: Design and methods* (4th Ed.). Thousand Oaks, CA: Sage.
- Young, M. N., Peng, M. W., Ahlstrom, D., & Bruton, G. D. (2002). Governing the corporation in emerging economies: A principal–principal perspective. *Academy of Management Proceedings*, 2002, E1– E6.

Figure 1
The Formal Structure of The Hoosier Coalition
PPP to Modernize Indiana's Welfare System Welfare

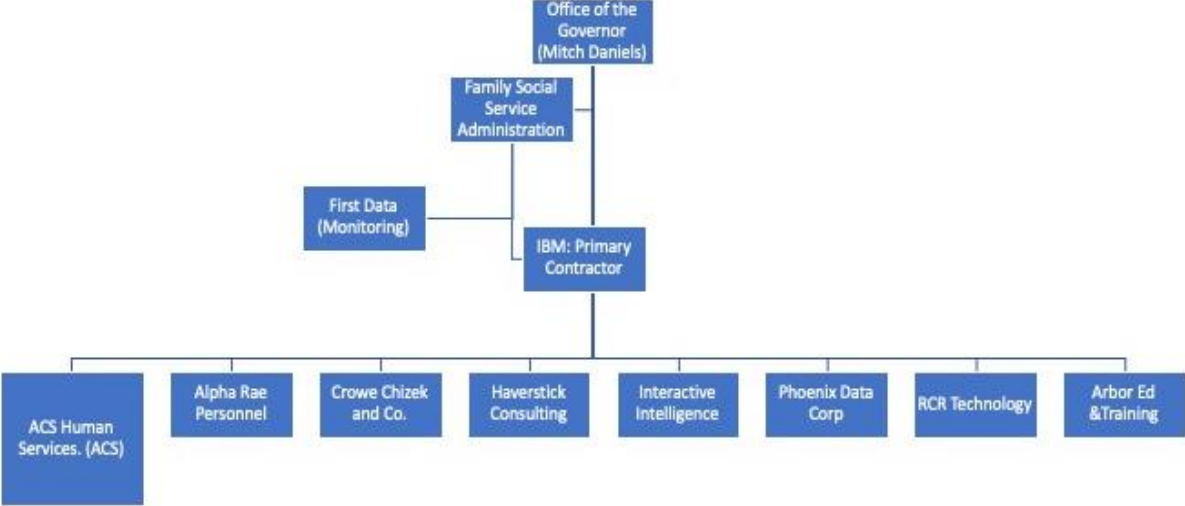


TABLE 1
Case Study Data Sources

Type of Data Source	Number of Documents and Pages Reviewed	Description
Contract Documents	12 contracts, over 900 pages	Review includes documents preceding contract (incorporated by references in contract)- Request for Information (RFI's), Statement of Work (SOWs); also includes original master service agreement between FSSA and IBM with exhibits appendices and schedules and 4 amendments; contracts between Indiana and main subs- First Data Indiana and ACS, Indiana and Arbor
Change Orders	92 change orders	Change orders also detail problems incurred during implementation. 4 categories: 1. anticipated updates to MSA (e.g. adding property addresses as leases are added) 2. accommodations related to unanticipated events (e.g. expanded work scope or assignment of duties to address new federal policy) or disaster relief (e.g. extending dates, establishing new milestones). 3. accommodations for events that could have been anticipated but were not in original MSA (e.g. HIP -related tasks) 4. change orders to address work coordination issues and formal complaints (dealing with delays, job clarification, naming new managers, addition of clerical staff, new training
Court Filings	5102 pages	Complaints, Responses, Motions, Judge Orders in State of Indiana v. IBM (Cause No. 49D10-1005-PL-021451); Complaints, Responses, Motions and Orders in IBM v. ACS (Cause No. 49A02-1301-PL-49); Complaint of American Civil Liberties Union (May 2008); Complaint in Thorb v. Roob; 12 motions for summary judgement; Appeals Court filings; Supreme Court filings
Court Transcripts	106 accounts	Excerpts from testimony and court depositions
Government Reports	8 separate reports, 221 pages	Background reports; Legislative reports; Committee reports, First Report on Issues Related to Organizational Structure of FSSA (August 2004); Government Performance Report; minutes from Gen. assembly; Interagency Report (June 2006)
Other Reports	6 reports from non-governmental parties	AFSCME (October 2005); Xerox case study; KPMG Report (June 2005)
Press	22, 109 pages	Press accounts and Press releases between August 2006 and May 2014
Personal Correspondence	261	different letters and emails reviewed from key actors in case, most are referenced in court filings.
Interviews	33	Semi-structured, open-ended interviews of key actors including government employees and contractors

TABLE 2
Interview Questions

Question Type/ Goal	Questions about Significant Events
Open Ended/ Prompt recall of significant events	Thinking about the project from the beginning in January 2007 to when it ended in September 2009, what events do you recall as most significant? These can be major milestones, a change in policy or personnel, or whatever comes to mind.
Follow up Questions/ to pin down details/ jog memory	Can you explain what happened? Why was this significant? What led to this? How was this perceived? Can you give an example? When did this occur? (referring to first event mentioned) ? In your opinion what precipitated this (referring to first event mentioned) ?
Question on Change Orders	
Open Ended/ Prompt	I can see from the records that were more than 90 change orders. Why do you think there were so many change orders?
Follow up Questions/ to pin down details/ jog memory	Can you explain what how the change order came about? Did the change improve plan? How did employees react to the change?

Table 3
Contract and Amendments: Dates and Details

Contract Document/Event	Date	Details
Initial Contract	Dec 27, 2006	\$1.3 million. Initial Master Service Agreement (MSA) signed between State of Indiana Family Social Service Agency (FSSA) for modernization of welfare system. IBM named primary contractor. Contract is for 10 years.
First Amendment	Jan 14, 2008	Adds about \$44.2 mil to fiscal year 2017. Adds clerical staff (backdated to 7/1/07); changes in personnel assignments
Second Amendment	April 15, 2008	Adds \$129.9 million to fiscal year 2017; adjustments in staff and roles; revised communication plan; expands scope of work for Healthy Indiana Program (HIP); delays milestones 7-10
Third Amendment	Oct 14, 2008	Adds about \$285,000 to contract; new schedule to accommodate “higher than anticipated number of HIP applicants); additional IT investment from IBM; implement TANF rules published in Fed Reg (Feb 2008); expands scope of work for new Medicaid program
Corrective Action Plan (CAP) Adopted	March 2009	Opportunity to Cure per MSA documents
Fourth Amendment	April 21, 2009	Adds \$47.3 million to contract; clarification of duties; change in project manager; adds staffing and training; adds tech support for HIP and State’s disaster assistance efforts; (Total added funds to date: \$180 million).
End of PPP	Oct 2009	New PPP arrangement begins. IBM no longer primary contractor.