Flexibility in Contracts and Contractual Practice: Empirical Study in China

YANAN ZHANG,[1] RIITTA AHTONEN[2]

The aim of the research is to examine how companies prepare for changes in business environment and networks in international business contracts; and how flexibility is introduced and adopted in the context of multi-cultural business. Our primary method is to interview managers, and lawyers who have experience in complex international business projects. The research mainly focuses on three different industries: construction business, information technology, and industrial equipment and maintenance services (e.g. automation systems). Thirteen interviews in China are conducted; then interview data are transcribed and analysed. Several findings emerge from analysis of the interviews. Firstly, most interviewees recognize the necessity of flexibility in long-term international contracts in order to deal with uncertainty and to solve disputes. Secondly, lawyers prefer rigid contract clauses and formal enforcement mechanisms and managers prefer good personal relations and informal enforcement mechanisms to respond to the changes of circumstances. Thirdly, the preventive and proactive approach, especially its role in preventing and resolving disputes between business partners, is widely recognized by Chinese mangers and lawyers. Empirical study on the topic in other countries is encouraged, so as to enable us to compare contracting practices of companies in similar industries in different countries. Managers and lawyers are advised to adopt a more cooperative attitude towards each other, and to establish more interactive and effective communication channels. Empirical study on this topic is rarely done. It is important both to the academic and business community to know how flexibility is approached and dealt with in contract and practice in China.

1. Introduction

1.1 Research background

With over thirty years' economic reforms and development, especially after being a member of the WTO, China has undergone significant changes and started to play an important role in international trade. According to A.T. Kearney's 2012 FDI (Foreign Direct Investment)

[1] Lecturer and researcher, International Law School, Shanghai University of Political Science and Law, Shanghai, P.R. China, yanan2@hotmail.com or yananzhang6@163.com
[2] University Lecturer, University of Eastern Finland, Joensuu, Finland, riitta.ahtonen@uef.fi

Confidence Index, China is ranked top as the most attractive destination for FDI in the world. The EU and China consider each other as an important economic partner. Business transactions between European countries and China are increasing.

Being a big developing country, China has a different social and legal system. China considers itself a social system with Chinese Characteristics. Accordingly, the Chinese legal system is labelled as "a social system of laws with Chinese Characteristics".[3] By the end of 2010, China has established a comprehensive modern legal system with the Constitution as the head and civil, commercial laws and several other branches as the mainstay. The new Contract law, which unified China's previous contract laws, came into effect on 1 Oct. 1999. This more advanced and systematic contract law is at the core of China's socialist market economy, and plays an essential role in fostering transactions.[4]

However, the Chinese legal system is criticized on grounds that a consistently enforced legal framework is absent owing to the lack of both professional competence and independence from political interference. Judicial corruption worsens the problem.[5] In addition, centuries of philosophical, political, and cultural traditions can be barriers to enforcement of new laws; hence the sanctity of contract and contractual enforcement in China are questionable.[6]

It has long been observed that *Guanxi* (relations or connections), are important factors when doing business with Chinese partners.[7] Conventional institutional analysis indicates that emerging economies will transition from personal connections to rule-based institutions; but if laws are not enforced in a consistent manner, legal institutions do not create the level of

[3] Information Office of the State Council of PRC, White Paper "Socialist System of Laws with Chinese Characteristics", Oct. 2011, Beijing, available at <http://www.fmprc.gov.cn/ce/cede/det/zt/zgzfbps/t872739.htm>, accessed 12 Sep. 2014.
[4] Zhai, Yuanjin (2009) "Chinese Contract Law and the Economic Reform",*Transition Studies Review*,Vol. 16 (pp. 429–437).
[5] Peerenboom, Randall (2002) *China's Long March Toward Rule of Law*. Cambridge University Press, (pp. 280-282 and 295-298).
[6] Pattison, Patricia and Herron Daniel (2003) "The Mountains are High and the Emperor is Far Away: Sanctity of Contract in China",*American Business Law Journal*, Vol. 40, (pp. 460 and 509).
[7] Zhu, Yunxia; Baht, Ravi and Nel, Pieter (2005) "Building Business Relationships: a Preliminary Study of Business Executives' Views",*Cross-Cultural Management: An International Journal*, Vol. 12, Iss. 3, (pp. 63–84).

stability and certainty necessary for supporting the use of contracts.[8] A theory of governance introducing two modes of economic governance (relation-based vs. rule-based) is proposed and also the application of such theory is extended to explain strategic management and international business.[9]

However, the use of contract is still prevalent in China, although the Chinese legal system is relatively weak.[10] One possible reason for this paradoxical phenomenon is the claim that relational governance, a social institution, provides contractual assurance. Empirical study findings broadly support the idea that relational governance functions supplement weak formal enforcement, thus promoting the use of the contracts in China.[11]

Three main concepts are used in the paper: long-term contracts, projects and relational contracts. The choice of which different concept to use at any given point depends on both theory and particular factual circumstances.

Long-term contracts cover contracts with a series of successive performances during a long time period, or contracts involving complex projects that include planning, designing, manufacturing, installing and maintaining the objects of transactions. Long-term contracts differ from spot-contracts by having a longer time dimension between the promise and performance. The long time dimension and the complexity of contracts make it difficult for the contract parties to foresee all probable changes of circumstances and prepare for the risks ex ante in the contract.

Macneil (1978) has classified contracts into three types: classical, neoclassical and relational contracts.[12] Compared with discrete contracts, relational contracts are longer in term, are

[8] North, Douglass C. (1990) *Institutions, Institutional Change and Economic Performance*. Cambridge: Cambridge University Press; North, Douglass C. (1992) "Institutions and Economic Theory", *The American Economist*, Vol. 36, No.1 (pp. 3–6).
[9] Li, Shaomin; Park, Senug Ho and Li, Shuhe (2004) "The Great Leap Forward: The Transition from Relation-Based Governance to Rule-Based Governance", *Organizational Dynamics*, Vol. 33, No. 1 (pp. 63–78).
[10] Zhou, Xueguang; Zhao, Wei; Li, Qiang and Cai, He (2003) "Embedness and Contractual Reltionships in China's Transitional Economy", *American Socilogical Review*, 68, (pp. 75–102).
[11] Zhou, Kevin Zheng and Poppo, Laura (2005) "Relational Contracts in China: Relational Governance and Contractual Assurance". Conference paper, available at <http://mba.tuck.dartmouth.edu/mechanisms/pages/papers/zhoupoppo.pdf>, accessed 09 Mar. 2013.
[12] Macneil, Ian (1978) "Contracts: Adjustment of long-term economic relations under Classical, neoclassical and relational contract law", *Northwestern University Law Review*, 72 (5), part 2 (pp. 854–905).

more difficult to articulate clearly and fully at the outset (and thus typically include open terms, reservations of discretion, and dispute resolution mechanisms), and involve greater interdependence both between the parties and between the parties and others interested in the transaction.[13] In relational contracts the disputes are resolved by private ordering with mutual renegotiations and mutual future planning in order to maintain a win-win situation between the parties.

1.2 Changes of circumstances and flexibility in international business

Nowadays international business environments change quickly; high uncertainty and unexpected circumstances are prevalent in international projects. This presents challenges to international business companies involved in complex long-term contractual relationships.

Some scholars argue that flexibility is needed to deal with changes of circumstances and uncertainty in businesses.[14] Because of the difficulties in dealing with the uncertainty of the future the parties must find a way to secure commitment if the circumstances change unexpectedly during the contractual relationship. When perfect contracting is impossible and if third-party enforcement is costly for the parties, parties seek alternative institutional mechanisms to solve commitment problems.

Under such situations, companies will have to require the skills of flexible adaptation to changing circumstances. However, a multi-case study showed that while flexibility is frequently called for in projects, it was rarely prepared for.[15] Another study demonstrated that the link of flexibility to contracts is often through relational methods, considering personal relationships between contracting parties or negotiation power and skills.[16] A co-operative attitude is indeed essential for dealing with contingencies in long-term contracts; otherwise,

[13] Spieldel, Richard (2000) "The Characteristics and Challenges of Relational Contracts", *Northwestern University Law Review*, Vol. 94 (p. 823).
[14] Kreiner, K. (1995) "In Search of Relevance: Project Management in Drifting Environments", *Scandinavian Journal of Management*, Vol. 11, No. 4, (pp. 335–346).
[15] Olsson, Nils O.E. (2006) "Management of Flexibility in Projects", *International Journal of Project Management*, Vol. 24, Issue 1, Jan. (pp. 66–74).
[16] Nystén-Haarala, Soili and Lee, Nari and Lehto, Jukka (2010) "Flexibility in Contract Terms and Contracting Process",*International Journal of Managing Projects in Business*, Vol. 3, Issue 3 (pp. 462–478).

formal provisions on flexibility will not work effectively.[17]

In international business contexts, cultural issues are also an important factor. "Contractual culture" emphasizing contracting parties' relations, understandings, and values may have a great effect on parties' contractual relationship.[18] Different "contracting cultures" may indicate a barrier for flexibility. Project managers from different cultures but working in the same project team may bring multiple and divergent systems of project structures and boundaries for dealing with unexpected events.[19] This study further illustrated the highly different approaches that Finnish and Chinese project managers adopted. The Finnish one placed reliance on formal structures and contracts; while the Chinese one emphasised social structures and networks.[20] Such differences can add to the difficulty of cooperating with changes of circumstances in an international project.

1.3 Research aim, questions, originality and methodology

The aims of the research are to examine how companies prepare for changes of circumstances in international long-term business transactions, and how flexibility is introduced and adopted in such contractual relationships.

The main research questions of interest are as follows: is flexibility needed and why is it important? How do contract partners deal with changes of circumstances in contracts and contractual practice? How have contract partners resolved their disputes in contract implementation? How is flexibility reflected in long-term contracting?

A recent literature review on the topic of empirical studies of contracts spanning several disciplines (mostly law, economics, and management) found that eight categories of empirical questions have been addressed.[21] But empirical questions on the topic of flexibility

[17] Campbell, David and Harris, Donald (2005) "Flexibility in Long-Term Contractual Relationships: The Role of Co-operation", *Lean Construction Journal*, Vol. 2, Issue 1, 5 (p. 13).
[18] Schmitz, Amy J. (2007) "Consideration of "Contracting Culture" in Enforcing Arbitration Provisions", *St. Johns Law Review*, Vol. 81 (p. 123).
[19] Tukiainen, Sampo and Aaltonen, Kirsi and Murtonen, Mervi (2010) "Coping with an Unexpected Event – Project managers' Constrasting sensemaking in a Stakeholder Conflict in China", *International Journal of Managing Projects in Business*, Vol. 3, No. 3 (pp. 526–543).
[20] *Ibid.*
[21] Eigen, Zev J. (2013) "Empirical Studies of Contracts". Northwestern University School of Law,

in contracts have not been conducted. Such empirical study on this topic in China is rarely done. We consider that it is important both to the academic and business community to know how flexibility is approached and dealt with in contracts and practice in China.

In this research, we approach "contract" as a dynamic process (including contract negotiation, formation, implementation and so forth), not just a static contract document or contract law.[22] Thus, the empirical study examines not only contract documents, but also contractual practice; questions covered different phrases that a project can be in, such as preparation stage, contract drafting, and contract implementation.

The research is meant to be qualitative research. The primary research method is semi-structured interview. In Chapter 4 about interview data analysis, we employ content analysis and thematic analysis as main methods. In Chapter 5, we also use economic analysis.

2. Research Theoretical Background

We consider that it is proper to employ new institutional economic analysis of contracts and relational contract theory to explain long-term contract issues, and use these approaches as theoretical bases of the research. To analyse how international companies located in China prepare for changes of circumstances and how flexibility is reflected in contracts and contractual practise we use economic analysis and relational contract theory. The choice of how an economic organization arranges its operational and production functions is strongly influenced by the political, cultural and legal framework of the society where the company is located. These decisions can be analyzed with the tools of economic theory.[23]

Relational contract theory appreciates the context of the exchange, and focuses on the necessity and desirability of trust, mutual responsibility and connection.[24] Therefore,

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Law and Economics Series, No. 12-02, avaiable at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1998483>, accessed 19 June 2013.

[22] Nystén-Haarala, Soili and Lee, Nari and Lehto, Jukka (2010), note 16 above.

[23] Matthews, R. C. O. (1986) "The Economics of Institutions and the Sources of Growth". *Economic Journal*, Vol. 96 (pp. 903–918).

[24] Feinman, Jay (2000) "Relational Contract Theory in Context". *Northwestern University Law Review*, Vol. 94 (p. 737).

relational contract theory is a valuable approach to contracting with Chinese partners. But an economic view argues relational contracting in China is becoming relatively more costly, considering the elements of diseconomy of scale and its undermining of the development of arm-length transactions and formal institutions.[25]

2.1. Transaction costs economics and incomplete contracts theories

Transaction costs economics (TCE) is one of the dominant frameworks for analyzing contractual and governance structures associated with the economic exchange. According to TCE the choice of the right governance structure depends on the costs of transacting business. TCE holds that allocating scarce resources in the market is not frictionless, but there is always a cost to the exchange process.[26]

The costs of concluding a contract can be divided into ex ante and ex post transaction costs.[27] Ex ante transaction costs arise from the costs of drafting, negotiating and safeguarding an agreement. Ex post costs of contracting include maladaptation costs, haggling costs, the setup and running costs of resolving the disputes and the bonding costs of effecting secure commitments. Ex ante and ex post costs are interdependent so that the more carefully and completely a contract is drafted, the higher are the ex ante costs and the lower are the ex post costs and vice versa.

According to the theory of incomplete contracts all contracts remain more or less incomplete. If the parties wrote a complete contract, which would specify a course of action contingent on every possible future state of the world, ex ante transaction costs would rise very high.[28] Another reason for incomplete contracts is bounded rationality. Because of the limits of

[25] Wang, Yongqin and Li, Ming (2009) "Costs and Benefits of Relational Contracting in China's Transition", *Transition Study Review*, 16 (pp. 693–709).
[26] Coase, Ronald (1960) "The Problem of Social Cost" *Journal of Law and Economics*, Vol.3, (pp. 1–44).
[27] The recognition of transaction costs comes already from the seminal work of Ronald Coase (1937) "The Nature of the Firm", *Economica*, Vol. 4, (pp. 386-405), but it was Oliver E. Williamson, who distinguished the costs as ex ante and ex post transaction costs. Williamson, Oliver E. (1985) *The Economic institution of Capitalism*. New York: Free Press, (p. 20-21).
[28] Klein, Benjamin (2000) "The Role of Incomplete Contracts in Self-Enforcing Relationships", *Revue d'économieindustrielle,* Vol. 92, 2e, (pp. 67–80 and 69). See also Ayres, Ian and Gertner, Robert (1989) "Filling Gaps in Incomplete Contracts: An economic theory of default rules", *The Yale Law Journal*, Vol. 99, 87–130.

human cognition people lack knowledge, foresight and the skill to accurately predict and plan for all the possible contingencies that may arise in the future. In addition, people cannot accurately describe actions and states of the world in the contract--especially on matters in which they have little prior experience.[29]

Rational contracting parties may optimise ex ante and ex post transaction costs by leaving contracts incomplete. The parties may leave the contract incomplete also because of high enforcement costs. Enforcement costs can be high, if the parties do not trust the public enforcement system. Another reason for high enforcement costs is that the uncertain states of the world can be difficult to verify in court.[30]

Incomplete contracts have obvious advantages over fully specified contracts, because they bring flexibility in contracting. The parties can renegotiate and reassess their initial responsibilities only if an unanticipated change of circumstances arises. Ex ante costs are unnecessary because unlikely events can typically be prepared for at lower costs after the relevant information is revealed.[31]

There are also disadvantages connected with incomplete contracts. An incomplete contract may induce one of the parties to opportunistic behaviour, which may manifest itself in moral hazard, shirking and other forms of strategic behaviour.[32] Once a contract is concluded a change of circumstances may offer one party an opportunity to behave strategically by stealing a larger share of the common profit than was originally agreed in the contract. For example, the promisee may turn down renegotiations and instead ask the court to enforce the contract, if a change of circumstances makes it more profitable for him to do so.

[29] Simon, Herbert (1955) "A Behavioral Model of Rational Choice", *Quarterly Journal of Economics*, Vol. 69, (pp. 99–118).
[30] Schwartz, Alan and Scott, Robert (2003) "Contract Theory and the Limits of Contract Law", *Yale Law Journal*, Vol. 113, (pp. 541–618).
[31] Klein, Benjamin (2000) "The Role of Incomplete Contracts in Self-Enforcing Relationships" *Revue d'économieindustrielle*, Vol. 92, 2e, (p. 69).
[32] Williamson, Oliver E. (1985) *The Economic institution of Capitalism*. New York: Free Press, (p. 20-21).

2.2. New institutional economics theory

In the New Institutional Economics (NIE) the social analysis of economic organizations is divided in two categories: "institutional environment" and "institutional arrangements".[33] Institutional environment consists of formal and informal rules of the society. Formal rules, like the constitution, laws and property rights structure the legal environment in which human actions take place. Informal rules, like social norms, customs, traditions, conventions and religions structure the social environment by defining the codes of conduct and norms of behaviour. Both formal and informal institutions influence behaviour by increasing or restraining incentives to behave in a certain manner.

How does the institutional environment affect transactions? According to the economic analysis of law the role of legal institutions is to achieve effective and low-cost contract enforcement. For example, the role of contract law is to influence rational beliefs of contracting parties about the likelihood of performance and thus to increase the parties' confidence in performance.[34]

The parties' confidence in the legal institutions is dependent on the effectiveness of the institutions and the legal system of a society. Similarly, the effectiveness of contract law as an institution is dependent on the role of many other legal institutions, like courts and judges, lawyers or governmental organizations.[35]

If the legal system in a society is weak, contracting parties do not trust in the legal institutions, but prefer instead private ordering.[36] In many instances the contracting parties can find more satisfactory private solutions to solve their contractual disputes.[37] Private informal

[33] See Williamson, Oliver E. (1985) *The Economic institution of Capitalism*. New York: Free Press and Williamson, Oliver E. (2000) "The New Institutional Economics: Taking Stock, Looking Ahead", *Journal of Economic Literature*, Vol. 38, (pp. 595–613).
[34] Posner, Richard (2003), *Economic Analysis of Law*, 6th Edition, New York:Aspen Publishers (p.93).
[35] Hadfield, Gillian K. (2008) "The Many Legal Institutions that Support Contractual Commitments" in Ménard, Claude and Shirley, Mary M. (eds.) (2008) *Handbook of New Institutional Economics*, Berlin/Heidelberg: Springer Verlag (pp.175-204).
[36] North, Douglass C. (1992) "Institutions and Economic Theory", *The American Economist*, Vol. 36 (1), (pp. 3–6).
[37] Galanter, Marc (1981) "Justice in Many Rooms: Courts, Private ordering and Indigenous Law", *Journal of Legal Pluralism*, Vol. 19, (pp.1–47).

mechanisms can also reduce contracting costs and increase the credibility of commitments better than court ordering.[38]

How should an economic organization choose the best governance structure? Institutional arrangements are governance structures chosen by the economic organizations themselves to govern their own relationships. According to Klein, P. (2000) the appropriate governance structure depends on the characteristics of the transaction. For example, a long time dimension between promise and performance causes uncertainty about the promisor's ability to act as agreed. Also the complexity of the transaction increases uncertainty about the future.[39]

Long-term contracts are one mode of governance in the organization's governance structure. According to the theory the commitment problem arises only if the change of circumstances has made a gap between the promisor's ex ante and ex post incentives. How the promisor acts at the time of performance depends on the promisor's ex post incentives. The purpose of the alternative enforcement mechanisms is to bring ex post incentives in line with ex ante agreements to produce the outcome the promisor has promised. The enforcement mechanisms share one common feature, which is that they increase the promisee's confidence in getting the value of the promised performance.[40]

One informal enforcement mechanism is self-enforcement. The self-enforcement mechanism is based on the threat of termination of the relationship, which would harm both of the parties: the promisee party could not recover from the investment and the promisor party would lose expected future profits. In order to create sufficient incentives for the promisor to perform, the loss of future profits due to the termination of the contract must be greater than the short-term gains of non-performance. The amount of each transactor's reputational capital determines the efficacy of the self-enforcement mechanism. When there is sufficient

[38] Mazé, Armelle and Ménard, Claude (2010) "Private ordering, collective action, and the self-enforcing range of contracts", *European Journal of Law and Economics*, Vol. 29, (pp. 131–153).
[39] Klein, Peter G. (2000), New Institutional Economics in Boudewijn, B and De Geest, G. (eds.) *Encyclopedia of Law and Economics* University of Ghent: Edvard Elgar (pp. 456-489).
[40] Hadfield, Gillian K. (2008) "The Many Legal Institutions that Support Contractual Commitment"s in Ménard, Claude and Shirley, Mary M. (eds.) (2008) *Handbook of New Institutional Economics*, Berlin/Heidelberg: Springer Verlag (pp.175-204).

reputational capital in the relationship, the parties will rely on self-enforcement rather than court enforcement.[41]

Another informal enforcement mechanism is reputation. Because reputation signals trustworthiness, companies have an intrinsic desire to maintain their good reputation.[42] According to TCE reputation has been characterized as a valuable specific asset. Acquiring good reputation is a company specific investment in the future. Good reputation reduces company's incentives to behave opportunistically and allows more flexibility in contracting.[43]

The self-enforcement mechanism and reputation mechanism work because they change incentives of the parties by changing the consequences of the actions. In the self-enforcement mechanism the termination of the relationship will end the quasi rents in the future and in the reputation mechanism the likelihood of future transactions with potential partners is threatened if the promisor defaults.[44]

2.3. Relational contracting theory

According to Macneil (1978, 1980, 1983, 1985), contract law has very little bearing on what contracting parties actually do. The relationship between the contracting parties is much wider and deeper than contract law assumes. The behaviour of the parties is guided by the internal norms of the contract but also by social customs and rules. Relational contract theory (RCT) was born as a critique against traditional contract law for ignoring the significance of the relationship between contracting parties. RCT has several approaches, but common to them is that they all emphasize the social and interpersonal relationships between contracting

[41] Macaulay, Stewart (1963) "Non-contractual Relations in Business: A Preliminary Study", *American Sociological Review*, Vol. 28, (pp. 55–67); Klein, Benjamin (1996) "Why Hold-Ups Occur: The Self-Enforcing Range of Contractual Relationship", *Economic Inquiry*, Vol. 34, (pp. 444–450) and Klein, Benjamin (2000) "The Role of Incomplete Contracts in Self-Enforcing Relationships", *Revue d'économieindustrielle*, Vol. 92, 2e, (pp. 67–80).
[42] Bergh, Donald *et al.* (2010) "New Frontiers of the Reputation – Performance Relationship: Insights from Multiple Theories", *Journal of Management*, Vol. 36, No. 3, (pp. 620–632).
[43] Williamson, Oliver E. (1991) "Comparative Economic Organization: The analysis of discrete alternative", *Administrative Science Quarterly*, Vol. 36, (pp. 269–296).
[44] Hadfield, Gillian K. (2008) "The Many Legal Institutions that Support Contractual Commitments" in Ménard, Claude and Shirley, Mary M. (eds.) (2008) *Handbook of New Institutional Economics*, Berlin/Heidelberg: Springer Verlag (pp.175-204).

parties instead of seeing the contract as discrete event between the promisor and the promisee, like the rule-based, classical contract law.[45]

Macaulay (1963) had earlier argued that in relational contracting the binding force of cooperation is not so much the commitment into a formal contract but the gaining of mutual benefits through cooperative relationship between the parties.[46] The mutual relationship gives room for flexibility in the contract, because instead of relying on the legal mechanisms the parties themselves govern the transaction by mutually accepted social guidelines. Also Macneil's (1980) approach towards business contracting introduces a degree of flexibility into the contract based on a common understanding of cooperative objectives, norms and collaborative activities.[47]

How does flexibility present itself in relational contracts? Where flexibility is incorporated into relational contracts, the contracting parties usually adapt their obligations to changed circumstances and unforeseen contingencies as they arise. According to mainstream approaches to relational contracts, the primary obligations originating from a long-term relational contract are a basis for future adjustments and variations to be made by the parties. Therefore, breach of implicit terms in a relational contract would be viewed as an occasion for renegotiation, readjustment, compromise and settlement. One study further indicates that appropriate rules for the excuse of contractual obligations may increase the cooperativeness and longevity of a wide range of long-term business relationships.[48]

[45] Macneil, Ian (1978) "Contracts: Adjustment of long-term economic relations under Classical, neoclassical and relational contract law", *Northwestern University Law Review*, 72 (5), part 2, (pp. 854–905); Macneil, Ian (1980) *The New Social Contract: An Inquiry into Modern Contractual Relations*, New Haven NJ: Yale University Press; Macneil, Ian R. (1983) "Values in Contract: Internal and External", *Northwester University Law Review*, Vol. 78, (p. 340) and Macneil, Ian R. (1985) "Relational Contract: What we do and do not know", *Wisconsin Law Review*, (pp. 483–525).
[46] Macaulay, Stewart (1963) "Non-contractual Relations in Business: A Preliminary Study" *American Sociological Review*, Vol. 28, (pp.55–67).
[47] Macneil, Ian (1980), *The New Social Contract: An Inquiry into Modern Contractual Relations*. New Haven, NJ: Yale University Press.
[48] Smythe, Donald James (2002) "The Role of Contractual Enforcement and Excuse in the Governance of Relational Agreements: An Economic Analysis" in *Global Jurist*, Vol. 2, No. 2, available at <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=799353>, accessed 10 June 2013.

2.4. Rigid contract vs. flexible contract

How the parties should choose between a rigid and flexible contract? The trade-off between rigid and flexible contracts is formalized with the incomplete contract theory including ex post maladaptation and renegotiation costs.[49] Maladaptation costs arise if the parties have not prepared for the unexpected changes of circumstances in the contract. Renegotiation costs are born from the ex post changes and adaptations when contracts are incomplete. Parties try to sign complete rigid contracts in order to avoid renegotiations and they sign flexible contracts in order to adapt contractual framework to unanticipated contingencies and to create incentives for cooperative behaviour.

Rigid contracts work as a guide in cases of doubt, and as a norm when parties do not find solution to their disputes. Another reason for preferring rigid contracts is that the magnitude of the private sanction that can be imposed is limited. A sufficiently rigid contract works as a complementary device for the self-enforcement system. Rigid contract terms shift reputational capital between the parties so that the parties have an incentive to perform in the future.

In a flexible contract there is the fear of hold-up, because the other party may modify the contract terms to appropriate the quasi-rents of a relation specific investment made by the other party. Relation specific investments are investments in assets which are worthless outside the relationship. Quasi-rents are earned profits in excess of post-investments opportunity costs that will be lost upon termination of the relationship. The other party may hold-up only if the one-time short term gain from hold-up is larger than the total discounted long-term gains from future performances. Rigid contracts will restrain hold-up and other forms of opportunism, because they reduce short-term gains from the non-performance and increase long-term gains from the future performances.[50]

[49] Athias, Laure and Saussier, Stéphane (2007) "Contractual flexibility or rigidity for public private partnerships. Theory and evidence from infrastructure concession contracts" in MPRA Paper No. 10541 . Available at <http://mpra.ub.uni-muenchen.de/10541/ >, accessed 10 Sep. 2014.
[50] Klein, Benjamin (2000) "The Role of Incomplete Contracts in Self-Enforcing Relationships" in *Revue d'économieindustrielle*, Vol. 92, 2e, (pp. 67–80).

Flexible contracts should be preferred when uncertainty is high and reputation costs are high. When uncertainty is low and the probability of hold-up is high, rigid contracts are preferred. A rigid contract should also be preferred if specific assets are high.[51]

3. Research design and data collection

3.1. Research design

The main data sources are studies of previous research on contracts and contractual practices, empirical data such as interviews, and information concerning respondents or respondents' companies.

Three major elements are covered in the research protocol: purpose, research questions, and the organization of the protocol. The purpose of the study is to examine how companies prepare for changes in quickly changing business environment; and how flexibility is introduced and adopted in contracts and contractual practices in international projects in China.

The organization of the protocol outlines the procedure of how to carry out the empirical study, including interview questions design, finding proper respondents, conducting interview, recording interview, taking notes during interview, transcribing interview, and data analysis plan. The targeted respondents are company executives, project managers, lawyers (including corporate legal counsels, and lawyers working in law firms) who have working experience in international business projects. The focus industries are construction business, information technology, and industrial equipment and maintenance services. But the study does not restrict itself within these industries. The main feature of a proper respondent company is that it has experience in long-term contractual relationships with its business partners, or in multi-cultural projects.

The guided and semi-structured type of interview (with outline of topics, issues or themes, but variation in wording and sequence is possible) is chosen, due to its major advantage of

[51] Athias, Laure and Saussier, Stéphane (2007) "Contractual flexibility or rigidity for public private partnerships. Theory and evidence from infrastructure concession contracts" in MPRA Paper No. 10541 . Available at <http://mpra.ub.uni-muenchen.de/10541/>, accessed 10 Sep. 2014.

obtaining somewhat systematic and comprehensive materials (Eriksson and Kovalainen, 2008). The structure of interviews in this study is divided into about seven sections or themes (general information on the respondent, projects and so forth; flexibility in contracts and contractual practice; barriers to flexibility in contracting; role of contract law and lawyers in contracting; informal institution; how to design flexibility in contracting; dispute resolution in contracting). Each section concerns a topic, under which several possible interview questions are included. Two versions of interview questions, which are slightly different, are designed and used for managers and lawyers.

3.2. Data collection

The primary activities in the data collection stage were collecting data on the respondents or their companies through the companies or law firms' web-pages in advance; and conducting interviews with project managers and lawyers. Before interview data were formally collected, we conducted 2 pilot interviews, which were to ensure questions are clearly worded and interview design is improved. Therefore, such pilot interview data are excluded in the final data analysis. We contacted with the Finnish Business Association in Shanghai, and asked friends or previous colleagues in China to act as referral to find proper respondents for interviews.

We gathered empirical data from three Chinese business companies, three Finnish business companies located in China, and four Chinese law firms, based on semi-structured qualitative interviews. The Chinese business companies have sufficient experience in international projects; but their fields of business and size are at different levels. The Finnish business companies operated in China mainly have project partners in China. Among the 13 respondents are 5 managers, 4 legal counsellors in companies, and 4 lawyers working in different law firms.

Table 1: List of Respondents

Company/ Location	Industry	Number of Manager Interviewed	Number of Lawyer Interviewed
C1 (Beijing)	Construction	1	1
C2 (Beijing)	Construction	1	0
C3 (Shanghai)	IT	1	0
F1 (Shanghai)	Pulp and paper	1	1
F2 (Shanghai)	Industrial equipment and maintenance services	1	1
F3 (Shanghai)	Industrial equipment and maintenance services	0	1
L1 (Beijing)	Law firm	0	1
L2 (Beijing)	Law Firm	0	1
L3 (Hangzhou)	Law firm	0	1
L4 (Shanghai)	Law firm	0	1

(C means Chinese Companies; F refers to Finnish Companies; L refers to Law firm)

As all interviewees are Chinese people, the researcher chose Chinese language as the interview language, although it was possible to conduct an interview in English. We recorded the interview and took notes at the same time. The data were collected in two ways: face-face interview; and written answers to interview questions. Use of a tape recorder in the interviews assisted with data collection and accuracy. Notes were also taken during and after the interview.

During face-to-face interviews, 2 interviewees (F1, F3, corporate legal counsel) did not allow recording, so the contents of the interview was made based on notes that were taken during

interview and later memory. For the rest of the 9 face-to-face interviews, interviews were properly recorded, and notes were taken. All the face-to-face interviews were conducted in respondents' offices. The researcher later reviewed the record and notes, and translated the interviewees' key ideas and sentences from Chinese into English, but did not transcribe word for word. There were 2 written answers to interview questions (from C3, manager; L4, lawyer) due to the difficulty of arranging interview time, and thus documents were translated from Chinese into English. Based on the companies' and interviewees' requests, related names of either company or interviewee are used anonymously.

4. Interview data analysis

4.1. Formal institutions in contracting

4.1.1. Written documents; attitudes towards contracts; role of contracts

This part describes the variety of written documents used by project partners, their attitudes towards contracts, and their opinions on the role of contracts. Through interview data, it was found that usually the written document is a formal contract. Many times communication would be done before signing a contract (C2, F1, manager). Sometimes, memoranda of understanding during meetings are important (C2, F1, manager). Faxes, emails, and purchasing orders are also written documents that reflect the requirements of customers; double-checking on customers' requirements before confirmation is a common practice (F2, manager). Most respondents considered that they understand their customer's requirements or tasks very well (C2, F1, F2, manager). It is necessary to get to know and understand them very clearly, as potential risks are involved. Sometimes, changes are reflected in written meeting memoranda after contracts have been signed (F1, manager).

Concerning the issue of attitude of companies towards contracts, generally, companies in China gradually realized the importance of contracts, and nowadays take contracts and contract processes quite seriously. Depending on the size of company, the particular industry a company is in, and whether foreign business partners or governments are involved in projects, the attitudes of companies toward the contracts can vary. Comparatively speaking, big companies, state-owned companies, and foreign companies take contracts seriously (L1, L3, lawyer; C2, F2, corporate legal counsel); whereas some domestic Chinese companies do

not (L1, L3, Lawyer). Many domestic Chinese companies still disregard the importance of contracts, but focus on development of good relationship with governments (L1, lawyer). It is recommended that business parties in general should respect contract, follow contract clauses, and implement contract properly (L1, lawyer).

The respondents also explained the role of contracts. Firstly, contract is an important and necessary document to sign between parties. Contracts are considered as a guarantee and protection for business transactions; and are also crucial documents in resolving disputes (L3, L4, lawyer; F2, corporate legal counsel; C2, F1, F2, manager).Usually, projects are made of different contracts, which are reflections of different business processes in written form (L2, lawyer).Secondly, contracts provide guidance for business cooperation, and are the basis for project implementation (C2, F3, corporate legal counsel; C2, F1, F2, manager).

From a different perspective, a contract can also become a preventive tool (F3, corporate legal counsel). Risk control and management are considered critical for companies, and contract management is one part of risk control (F1, corporate legal counsel).

4.1.2. Role of contract law in contracting

This section discusses the role of contract law and lawyers in Contracting. Firstly, we examine respondents' comments on Chinese contract law. Generally, contract law itself is quite advanced, has sufficient force, and provides good guidance and protection for business parties (C1, C2, F1, F2, manager). Two company managers consider laws as a highly important framework; they will obey the laws during the whole stages of projects, and hope their project partners also work under legal frameworks (C1, C2, manager).

However, to some extent, good contract law does not operate well in practice; and enforcing the law can be difficult in China (F3, corporate legal counsel). It is well recognized that contract law is only one aspect; contract enforcement is a more important issue, which has close connections with legal practice (e.g. judges' professional quality) and business practice (e.g. contract performance by the parties)(L1, L3, lawyer). Familiarity with local culture, including aspects of business, legal, tradition, customs, helps to understand the issue of contract enforcement (F1, corporate legal counsel).

Furthermore, many judicial interpretations concerning contract law play a role in contract enforcement process. Sometimes courts interpret some clauses in a rigid manner, which restricts freedom of contracts (F3, corporate legal counsel). Sometimes, a poor quality judge interprets some legal provisions in a wrong way (C2, corporate legal counsel). There are also certain restrictions in terms of policy, or regulations from the governments, which impede business parties' business activities (F2, corporate legal counsel). Enforceability of law, operation of courts, and quality of legal practitioners in China remain to be improved (L1, lawyer; F2, manager).

4.1.3. Role of lawyers in contracting

We further investigate when or at which phases lawyers are involved in business cooperation. Depending on different cases and different needs of projects, lawyers may be invited to engage in different phases, such as business negotiation before signing contracts, drafting contracts, signing contracts, project implementation, and if trouble/disputes arise. But lawyers are not necessarily involved in every stage, as features of legal services and clients' demands can vary (L3, lawyer). Similarly, legal counsel may not be involved in every stage of their company's business projects (F1, corporate legal counsel; C1, C3, manager). Where necessary, legal counsel may be involved in negotiation process (F1, manager). Many years' tradition in legal practice is that people usually come to lawyers only after problems arise. However, usually it is too late to come to lawyers after disputes arise, and business parties can face big losses (L1, lawyer).

In large projects, especially with international elements (e.g. foreign companies are involved), or in an unfamiliar country or place, business parties may invite legal counsel to participate business cooperation before signing contracts or invite lawyers for the whole process of projects, so as to avoid risks (C2, F2, manager; F3, corporate legal counsel). In addition, state-owned big companies, including listed companies, may also involve outside lawyers, besides in-house lawyers from their own legal department (L1, lawyer).This is considered a good practice, as this makes lawyers know the projects well, and this reduces and prevents potential risk; but this is not common in practice (L1, lawyer, interview).

Thus, improving the awareness of importance of law and contract in China is still a big task. Although there are calls to involve lawyers at early stages of business projects, traditional legal practice may still take time to change in companies.

Additionally, we examine who takes care of contract drafting in companies. In terms of the group who draft contracts, it depends on particular facts. Company lawyers, lawyers hired outside company, project managers, and so forth can be the contract drafters alone or together. After many years' experience, companies may have saved several different versions of model or standardized contracts suitable for different types of businesses. Sometimes managers are very clear which clauses are important in a contract; then they may just sign a contract by themselves (C2, corporate legal counsel). Sometimes, when the other party provides the contract, the company would only need to negotiate on certain important issues, such as price, quality of project, safety standards (C1, manager). Sometimes, clients have their contracts ready, and only require lawyers to review the contracts (L2, lawyer).

It is also interesting to see that in some companies, contract drafting is a teamwork and process; different professionals (such as marketing staff, projects managers, engineers, budget experts, inspectors, lawyers and so forth) participating in the project work together to draft contracts; different experts will take care of clauses of different subject matters in the contracts (F1, F2, manager;L1, lawyer; C2, manager and corporate legal counsel).Therefore, depending on different circumstances, contracts can be drafted by different groups.

4.2. Flexibility in contracting

4.2.1. Changes of circumstances in contracting

Changes of circumstances in international projects bring up the issue of flexibility. The study investigated what kind of changes of circumstances business partners have met with during project execution. During project implementation, changes of circumstances are quite normal in practice, particularly in industries such as construction, industrial equipment and maintenance services. Things can change significantly, especially during the period of financial crisis.

One manager considered that project implementation is a continuous process of dealing with changes (such as change of previous plans, extension of shipping period, changes of optimization of different subjects), and solving disputes and conflicts (C2, manager).Some are especially significant, such as changes of contracted materials' price, changes of government policy, government rules and so forth, which have big influence on both parties' performance of the contract (L1, lawyer).

The data include many concrete examples concerning changes of circumstances in projects after signing a contract. For example, within a construction project, after construction site investigation, the workload would be tremendously heavier than the contract specified; then extra costs were caused; or the project deadline may be extended after negotiation (C2, corporate legal counsel).In a 2-year (or longer period)-project, one party may change the scope of goods/products; delivery time can be delayed (F3, corporate legal counsel). Clients required changes of some equipment's function, or changes of design on some parts (C1, manager).In the IT industry, one respondent experienced changes (such as change of procurement on certain materials, change on indicators of equipment function, import and export formalities problems); but changes are not frequent, because most issues have been confirmed with the clients during the early bidding process (C3, manager).

4.2.2. Is flexibility needed in contracting?

Then we address the question of whether flexibility is needed in international projects. Most respondents considered that in projects, some aspects could be flexible; in terms of some issues that cannot be certain or clear, or for tailor-made products, some room for flexibility has to be left; a certain degree of flexibility would also be needed during project implementation in order to deal with unexpected circumstances and to solve disputes. Contracts cannot prescribe all situations: unexpected circumstances can arise at any phrase of the project.

Most answers towards flexibility are positive. Flexibility is even considered a kind of sub-consciousness and a must in projects (C2, manager).It is necessary to leave certain room for some flexibility, as customer's requirements can change during the project process (F1, manager). Moreover, being flexible or mastering flexibility in order to deal with changes and

keep cooperation with business partners is considered as skill and capability; a project manager has to grasp such a capability (C1, C2, C3, F1, F2, manager). A legal counsel similarly held that managers should be sensitive to changes, be capable of dealing with various changes flexibly (F3, corporate legal counsel).

A lawyer should also consider flexibility; otherwise, one cannot negotiate well in a later stage (L1, lawyer). According to two legal counsels, flexibility is also a task for lawyer, and others who are engaged in the projects (F1, F2). It is recognized that lawyers' task is to help and facilitate, rather than obstruct business cooperation (C2, corporate legal counsel).One pointed out that flexibility could be very important in terms of negotiation and contract performance (L2, lawyer). Where both parties perform their contracts in good faith, flexibility provides a buffer between two sides, and is beneficial to resolving disputes (F2, F3, corporate legal counsel). There are also negative attitudes towards flexibility. For example, one legal counsel does not like flexibility at all (F3).

The opposite of "flexible" can be "strict", "meticulous", or "certain". Where some elements in projects cannot be flexible, lawyers must try their best to make contracts clear, feasible, and enforceable.

At the same time, how to balance flexibility with certainty, thus how to make flexibility more meaningful is recognized and considered important (F2, manager). Flexible clauses should be included only when necessary (C2, corporate legal counsel). Too much flexibility is not acceptable and improper; otherwise, contracts lose value and meaning (L1, L2, L3, lawyer; C3, manager).One suggested that some principles have to be inserted to restrict flexibility (C1, manager). The combination of principles and flexibility is meaningful to successful project cooperation (F1, F2, corporate legal counsel).

Flexibility is like a paradox; on the one hand, contract should be clear and strict; on the other hand, during contract implementation, a certain degree of flexibility is necessary (L2, lawyer). When one can deal with flexibility well, efficiency of work will be improved; otherwise, flexibility can lead to mistakes, gaps, and losses (C1, manager).Therefore, people still prefer more certainty and feasibility, and less flexibility or would try to reduce flexibility to the lowest degree, although under some circumstances flexibility is necessary (F1, F2, manager).

In addition, the purpose of being flexible is to reduce or save the transaction costs (F2, corporate legal counsel), to try to continue performance of the contract; and to achieve

contract/business purpose and make business eventually successful (L1, L2, L3, lawyer; F1, corporate legal counsel, manager). The purpose of protecting clients' interests is also emphasised when considering the necessity of flexibility (L4, lawyer).

4.3. Flexibility in contract documents

Flexibility in contract documents is mainly reflected in words/phrases used in contract clauses; and contract clauses. Some contract clauses contain words or phrases indicating flexible meanings: For example, principle of rightness, principle of equity, good faith, good manner, important reasons, legitimate reasons, special circumstances, relatively, grave, serious and so forth. Whether the words/phrases can place some kind of obligations on a party is the key matter (F1, corporate legal counsel).We discuss this issue by using one lawyer respondent's basic classification (L1, lawyer):

The first group refer to phrases such as "good faith", "fair", "friendly negotiation", "principle of equity", and so forth. Those words stand for general principles that are widely accepted, and they do not make a big difference concerning parties' rights and obligations. The second group of words (such as "legitimate reasons")may place restrictive conditions. Such words should be clarified, and clearly written in contract. The third group are adjective and adverb, such as "grave", "serious", "as soon as possible". The meanings of such words are not clear, and thus such words are not suitable to be included in contracts. Parties should try to avoid using such words and try to make rights and obligations concrete (L1, lawyer).

Most respondents feel comfortable to accept the first group of words/phrases in contract documents (C2, C3, C1, manager; L1 lawyer). But certainly, words/phrases with certainty and clear meaning are preferred, while vague and ambiguous words are avoided.

Contract clauses that deal with changes of circumstances are discussed. Such clauses are: force majeure clauses, relief clauses, renegotiation clauses, clauses on certain principles, procedures or change mechanism and contract amendments. But usually lawyers prefer to consider as many circumstances as they can, and include them in contracts.

A "force majeure" clause (prescribing changing conditions such as a natural disaster) is quite typical. A relief clause is also common to be included in a contract. For example, after

investigation, a construction site turned out to be unsuitable for further construction, then both parties' obligations will be relieved (L1, lawyer). A third common clause is renegotiation clause. After renegotiation, clauses concerning amendment may also be added (C1, manager).

In addition, a clause on a change mechanism is sometimes included in a contract. For example, a clause can prescribe that if one party changes design requirements, how partners communicate and then understand fully the changes (F3, corporate legal counsel). In certain type of contracts, such as construction projects, there are contract clauses indicating the procedure of which party will do what (L1, lawyer). With such clauses, parties know how to proceed, thus conflict intensification can be avoided (L1, lawyer). It may help minimize the problem and promote smooth progress of the project (C2, manager).

Sometimes some subject matters are not certain even when the contract is signed. For example, concerning a construction project, when a contract is signed, the construction site may not be investigated fully or to a deep level. Some flexible clauses that deal with circumstances such as a construction site which is not suitable, or the construction area which is not big enough, need to be included in the contract document (L1, lawyer).But it is recognized that contract clauses dealing with flexibility need to be executed; the execution in turn relies on both parties' good faith in order to continue cooperation (L3, lawyer; C2, corporate legal counsel).

4.4. Flexibility in contractual practice

The section examined how business parties will do when facing change of circumstances (question to managers) and what kind of advice lawyers will provide to deal with change of circumstances in practice (questions to lawyers).

Facing changes of circumstances, or if changes cannot be avoided, business partners would firstly renegotiate or do further communication in order to work out a solution (e.g. C2, C3, F2, manager). Renegotiation is considered a reflection of flexibility (F2, manager).

Notifying the other party about changes immediately is usually done and is also considered necessary (C1, manager; F2, corporate legal counsel). In a company, usually business

partners will have communicated on problem of changes beforehand, thus one party will have some time to prepare needed resources for the changes, such as technology, materials, human resources, and so forth (C1, manager).Providing a reasonable compensation is also a possible solution (F2, corporate legal counsel).If necessary, contract amendments may be added, after business parties agree to the amendments (L2, lawyer; C1, manager).

In addition, with changes of requirements from customers (such as small changes on some parts, new standards), one important element for companies to consider is to ensure that needed changes are rational and legitimate. For example, companies usually will evaluate the risks and costs associated with the customers' changing requirements or whether it is necessary to fully meet with such demands; if the associated risks and costs are reasonable, companies would make changes accordingly (C3, F1, manager).

Sometimes, regarding changes on the deadline of a project or project payment, one prefers to keep some flexibility in practice, but not in contract documents. For example, in a contract, a date of deadline for payment is specified. If the partner is delayed for a certain number of days, but the delay is still within the time limits that the company can accept, the business cooperation will continue (F2, manager).

Depending on different circumstances, discharging a contract, stopping the cooperation or transferring the business to other partners are alternatives to deal with changes; but the impacts or harm of such alternatives have to be evaluated carefully beforehand (F2, manager).Parties will not simply ask for discharge of a contract after disputes arise.

Advice for dealing with changes of circumstances/contingencies from lawyers corresponds with that of business party respondents toward changes. Generally, the advice of how to deal with changes of circumstances has to be considered case-by-case. Different advice such as renegotiation, proper contract amendment, performance continuance or discharge of a contract may be given depending on different cases. Basically, contract clauses in original contract documents are important to look at, if disputes arise.

According to one legal counsel, before providing any advice it is crucial to get to know all the background details of one issue; if necessary, both legal and business perspectives must be considered carefully (F1). Contract or business purpose is also a key point to keep in mind (F3, corporate legal counsel).

All respondents recognized that negotiation is the first choice and an essential principle, and also is the best and the least-costly method of solving disputes. During the negotiation process, the lawyer should be clear what the clients' interests are; and also need to make the clients understand clearly their best interests (L1, lawyer). Furthermore, during negotiation cultural issues such as "face" or expressing an opinion indirectly, may be brought up. Knowledge of local rules and strategy or ideas applicable to Eastern people's thinking is important in resolving disputes (F1, corporate legal counsel).

Thus, to provide proper advice, besides contract documents and the facts, some other components such as cost, project/business purpose, both parties' negotiation power or position need to be taken into consideration.

4.5. Barriers to flexibility in contracting

The study further investigates what kind of barriers to flexibility there are in contracting. The first main question concerns a language element Most respondents consider that in general, different home languages are not a problem to business communication, where English becomes a commonly used working language (e.g. F1, corporate legal counsel; C3, manager). However, it is agreed that it is easier and more effective to communicate, thus being able to understand each other deeply with the same home language than a different foreign language (C1, F1, F2, manager; F2, corporate legal counsel; L2, L3, lawyer). In addition, different home languages can complicate and lengthen negotiation or resolution process; translating a lengthy agreement from one language to another certainly takes time (L4, lawyer).

On the contrary, one argues that language itself can to some extent become an obstacle, as different home languages mean different cultural backgrounds, expression styles and so forth and the understanding of certain language or concepts can be different (L3, lawyer; C2, corporate legal counsel). Moreover, depending on the level of English language skills, it can be a relatively small barrier (F3, corporate legal counsel).

The second question is about standard terms and conditions. Standard terms can refer to commonly used terms in different contracts, such as miscellaneous clauses, including "force majeure", dispute resolution, validity, and language. Moreover, they may include model contractual clauses typical in certain industry, or business fields. For example, in the

construction industry, many clauses are from FIDIC model clauses, which are internationally used in many countries. From the interview data, we found that standard terms and conditions or model clauses in contract documents come from various resources, such as governments, business associations, other business partners, previous work experience, industry custom and practice.

According to the respondents, there are recognized benefits of having standard or model contract clauses. Firstly, such model clauses can be modified by business parties, according to their own business features, needs, and interests, thus providing help for parties to prepare for their own contract documents (L1, L2, L3, lawyer). Secondly, they save time, energy and human resources for working and discussing on certain contractual clauses. Thus, all respondents consider they are not an obstacle to flexibility. On the contrary, flexibility can supplement standard terms and conditions (L1, L2, lawyer).

However, the cost of being flexible during project implementation has to be considered, as a company has to earn profits (C1, manager). Furthermore, the attitude of business partners towards flexibility can be an obstacle (C2, manager).

4.6. Informal institutions in contracting

The researchers are also aware of the possible influence of informal institutions in contracting implementations, thus addressing the informal institutions, particularly trust. All respondents recognize that besides contract document, many other elements (such as values, culture, reputation, personal relationship, trust, parties' stakes/interests, parties' status, good communication) also count in maintaining effective business cooperation. Particularly, good personal relationship between parties is important to contract performance; with good relationships, there will be fewer disputes, less doubt, and effective communication (L1, L2, Lawyer).

Trust plays an important role in good cooperation. Trust is considered the very basic precondition for contract and the key basis for business cooperation (C2, F1, F2, manager; F1, F2, corporate legal counsel; L1, L2, lawyer).Trust is also the basis for parties to cope with changes of circumstances together (C2, manager).

Respecting each other is a key for trust building; trust is one's feeling towards to the other, which is a kind of subjective criterion (F1, corporate legal counsel). One gets to know the other party and builds trust gradually; at the beginning, there is little trust, and trust can be increased over time (C1, C2, F2, manager).

It is rare for parties to do a project with a new partner at the first time. For companies who are in their first-time cooperation, strictly performing the contract (such as delivering projects, making payment on time) and honestly trying to resolve a dispute without delay are good behaviours that will make a party look trustworthy (F1, F2, corporate legal counsel).

But trust building is also based on objective criteria. Getting to know the other party well beforehand helps to evaluate whether one can fit and cooperate well with each other. One may judge whether the other party is trustable based on comprehensive integrated information collected concerning the other party (such as project experience, reputation, its technology level, performance capabilities, quality of service) (C1, C2, F2, manager).Knowledge of each party's requirements and available resources is also important to help both parties to build trust with each other (F1, F2, corporate legal counsel).

One party may also evaluate and verify trust relation by considering the other's past performance, previous behaviours through business cooperation with it (C1, C2, manager),or third-party business parties' knowledge or opinion of the other party (C2, manager).Thus, fulfilling one's own obligations is essential to establish and maintain trust between parties (L4, lawyer; C2, C3, F2, manager). Moreover, the other company's integrity, value congruence, its leader's personal creditability and ability, its management team's style and capacity are important elements to consider (C2, F2, manager).

Trust has an effect on flexibility in contracting. With high-level trust, certain costs can be reduced; flexible methods are easy to be adopted in contract performance; flexibly dealing with disputes is easy; a project is likely to be successful (C2, F1, F2, manager; F1, F2, corporate legal counsel; L1, L2, lawyer). In contrast, absent trust or with only low-level trust, changes of circumstances may be misused (C3, F1, F2, manager; F1, corporate legal counsel; L1 lawyer); being flexible can become difficult; flexibility may not be easily controlled, problems may arise from flexibility, and the end of the project would not be satisfactory (C2, F1, manager; L1, lawyer).

4.7.Resolving and preventing disputes

4.7.1. Dispute Resolution Methods

This section deals with methods for resolving disputes arising from change of circumstances in practice, and why a particular method is used. The interview data showed that disputes were finally resolved through negotiation, arbitration, or litigation. Usually, renegotiation (including direct communication) and trying to make compromises the preferred option for business parties after disputes arise (C1, C2, C3, F1, manager).The partners are considered as an interest group (F1, F2, manger); and long-term project cooperation objectives are highlighted during renegotiation process (F1, C2, manager). All respondents considered that the original contracts are the basis and an important tool to resolve disputes. Additionally, principles of impartiality and fairness are also stressed in dispute resolution process (L4, lawyer).

To resolve disputes through court litigation is very rare. Most respondents indicated that going to court to solve a dispute is only considered as the last resort when all other methods do not work out. Particularly in the construction industry, companies rarely go to court, since if disputes go to a court, a project has to be delayed or stopped and no party can bear the huge loss of delaying or stopping an on-going project (F1, lawyer; C2, manager). Some elements, such as what kind of loss(including reputation loss) it will lead to, whether one has the financial capability to continue the performance, will be considered and evaluated by the parties before going to court(F1, F3, corporate legal counsel; C2, manager).

However, there are also reasons to consider resolving a problem through litigation, such as litigation may lead to a better result than other methods (L3, lawyer); it is convenient for client to sue in a local court; or resolving the dispute is not so urgent (L4, lawyer).

Commercial arbitration is a common alternative method to resolve disputes. The arbitration institution, the China International Economic and Trade Arbitration Commission (hereinafter CIETAC) is widely recognized in China. Most respondents consider that resolving disputes through arbitration is better than through litigation. The differences of solving disputes between through arbitration and litigation are recognized and compared, according to their experiences.

First, arbitration provides chances for parties to choose substantial rules and make agreement on certain matters; thus parties may have more rights in arbitration than in litigation. Secondly, in arbitration, both parties have quite equal status. Arbitrators with good standing can be relatively impartial, and arbitration process is fairer than litigation. Thirdly, mostly arbitrators are experts in some particular industry, whereas judges are not. Fourthly, arbitration is confidential and the process is not open to the public. However, usually litigation has to be open to the public. Thus some business secrets can be better protected under arbitration.

Fifthly, arbitration procedure and process is simpler, shorter, and more flexible, transparent and efficient than litigation (L3, lawyer). The decision from an arbitral tribunal is final, and no appeal is allowed; whereas litigation allows appeal, entailing delay and higher costs. Sixthly, arbitration institutions, such as the CIETAC, basically are independent, and will not be negatively influenced by local governmental bodies in making awards. However, courts can be negatively influenced by local protection. Finally, enforceability is easier under arbitration, where an international Convention (New York Convention) assists the awards enforcement. This is especially meaningful in terms of international arbitral disputes.

In theory, commercial mediation is a common alternative for dispute resolution. However, it is surprisingly found that although mediation under court procedure is common in Chinese courts, commercial mediation is not known and not used to resolve business disputes in practice in China. One reason is that agreement reached through commercial mediation institution is not binding and valid, thus is not enforceable through the courts. Furthermore, the impartiality, function and benefits of commercial mediation are not clear to parties, and thus parties prefer arbitration (F1, legal counsel).

4.7.2. Preventive and proactive approach

This part examines the questions on how preventive and proactive approach is practiced. Preventing risks or bad things from happening is common sense (F2, F3, corporate legal counsel; C1, F1, manager). Signing contract itself is considered as a method of risk prevention; particularly, dispute resolution clauses are considered important (L2, L3, L4, lawyer). One lawyer suggested that preventing disputes should be considered in every case.

Questions such as how to prevent risk of disputes, how to resolve them when disputes arise, what procedure is better for clients' interests and so forth, should be considered when contracts are drafted (L1, lawyer).

This preventive and proactive approach is considered highly important and is applied in practice. In one company, risk management and prevention is highly valued; it also has a manual concerning risk management for its staff. In the manual, risks and preventive measures for such risks are listed carefully (C2, manager).Such approach is also applied in areas such as contract design and implementation (F2, F3, corporate legal counsel).A manager considered that taking good care of one's own task is essential in a project; and recommended that a company should not accumulate problems or conflicts. Once a problem occurs, trying to solve it immediately at the very early stage is the best (F1, corporate legal counsel, manager).

In addition, in long-term cooperation, regular communication within partners is considered as a good preventive practice (F2, manager). Sometimes, due diligence examination is conducted and experts opinions are collected in advance (L2, lawyer). At the same time, cost is recognized as an issue for parties to consider; preventive measures to guard against dishonest or potential risks may add some costs (C2, corporate legal counsel).

4.8. Suggestions to managers and lawyers in practice

Finally, the study investigates how good cooperation can be achieved between managers and lawyers, and considers suggestions from lawyers and managers to each other in their daily practice in order to effectively contribute to the success of projects. There are generally three suggestions to managers from lawyers. Firstly, managers should improve their awareness of the importance of law and contract, appreciate lawyers' role, invite lawyers to participate in business cooperation at early stages, and review their contracts, so that lawyers can provide proper legal opinions on certain issues beforehand (L1, and L2, L4, lawyer). With early engagement, lawyers can get to know more about the project and project process. Then lawyers may foresee potential risks during project implementation, and design some preventive measures for some particular problems (C2, legal counsel).

Secondly, managers should have general (but not necessarily extensive) knowledge in different fields, such as business, legal, and accounting; before making a business decision, managers should try their best to know the related issue well from many different points of view (including legal points) (L2, lawyer). Then they should seek proper experts to do things that they cannot do well (F1, legal counsel; L1, lawyer).

Thirdly, lawyers hope managers respect lawyers' working style, trust lawyers' expertise, and leave legal affairs for lawyers to deal with without unnecessary intervention (L3, lawyer). A good manager is a good partner of a lawyer (F1, legal counsel). Effective coordination and communication between lawyers and managers is required in order to cooperate well.

There are also a few recommendations from managers towards lawyers. Firstly, managers hope lawyers can take initiatives to know and then evaluate relevant international rules, local rules, customs, commercial policies in the foreign country where a project will be implemented; and provide more help and advice to managers in foreign/international projects (C1 and C2, managers).Secondly, lawyers will contribute more to preventing potential risks through better understanding of projects by engagement in earlier stages of projects (C2, manager).

Thirdly, it will be valuable if lawyers can review what has been done after each stage of project implementation during the project process, so lawyers may prevent potential problems in advance for the next stage; and provide a summary on what are good and bad practices after the whole project is completed (C2, manager).Fourthly, sometime lawyers consider too many potential risks, which preclude them from flexibility; thus lawyers should try to become more flexible (F1, F2, manager).

5. Main research findings

5.1. Is flexibility needed?

The respondents shared the opinion that flexibility in contracting is needed in order to deal with uncertainty and to solve disputes. To many of the respondents changes of circumstances were common and normal. They also agreed that contract cannot prescribe all situations: unexpected changes of circumstances can arise at any phase of the project.

The respondents' attitudes toward flexibility can be justified with economic terms. Uncertainty reduces contracting parties' confidence in performance and thus reduces willingness in contracting. Uncertainty reduces also the profitability of the transaction, because unexpected changes of circumstances may endanger the continuation of the transaction. Thus flexibility in contracting is needed to alleviate problems arising from changes of circumstances.

According to the respondents flexibility in contracting is also needed to reduce transaction costs. This statement can also be justified with economic terms. Parties can save negotiation costs because they do not have to negotiate about a procedure for all probable changes of circumstances at the time of concluding the contract. In addition, including a provision for each probable change of circumstances in the contract would increase contracting costs and would only make the contract complex and difficult to understand, which would increase ex post transaction costs. Thus, by leaving the contract flexible, contracting parties can save transaction costs.

However, the respondents seemed to invest in ex ante searching costs in order to get to know the future partner very well before concluding a contract. Investment in ex ante transaction costs is economically justified particularly in long-term contract relationships, in which the profits accrue in the form of constant stream of quasi-rents. Careful searching for a reliable partner can be seen as a preventive measure against the risk of changes of circumstances. Investment in ex ante searching costs reduces ex post transaction costs, because contract is concluded only with trustworthy and reliable partners.

Furthermore, some lawyers emphasised that flexibility is needed to protect clients' interests. Altruistic behaviour is not usually connected with neoclassical economic analysis but experimental research has proved that people are not satisfied with unequal share of common surplus.[52]Therefore during the contract performance, besides considering one's own interests, it is also necessary to try to balance the other party's interests.Investing in contracting and negotiation costs in order to conclude a mutually beneficial contract increases the value of cooperation and strengthens the confidence in performance.

[52] Güth, Werner; Schmittberger, Rolf and Schwarze, Alan (1982) "An Experimental Analysis of Ultimatum Bargaining", *Journal of Economic Behaviour and Organization*, Vol. 3, (pp. 367–388).

5.2. Flexibility in contract documents

The data analysis revealed that flexibility in contracting manifested itself in two ways, flexibility in contract documents and flexibility in contracting practise. In contract documents, flexibility is mainly reflected in flexible words/phrases used in contract terms and contract clauses dealing with changes of circumstances. The economic aim of flexible contract clauses is to alleviate the consequences of unexpected changes of circumstances which would otherwise destroy the original intention of the parties. For example relief clauses and force majeure clauses are justified if the costs of performance would destroy the promisor's business. In addition, some clauses concerning trade practises, trade customs or general standard terms are stipulated to be used in a certain field of industry. According to economic arguments these standards are efficient for most of the parties, because they represent the will of majority of the parties and they save time in negotiating these clauses.

The language used in contract clauses plays also a crucial role in allowing flexibility in contracts. Whether flexibility in contract clauses leads to good or bad result depends on the clarity of the words and phrases and the method of interpretation of the flexible clauses and principles.The equity and foreseeability of the court judgements depends largely on the legal culture. But since court enforcement is not the main dispute resolution mechanism, this has little bearing in practise.

The lack of common language may reduce flexibility and increase transaction costs. It is easier to communicate with home language than with foreign language. Because of different cultural background the concepts and expressions may have a different meaning than the party anticipated. Therefore different home languages may complicate negotiations and increase negotiation costs. Translation costs will also increase contracting costs. In addition, the danger of misunderstanding is greater than with common home language. Thus, different languages may increase ex post transaction costs.

5.3. Flexibility in contracting practise

Flexbility in contractual practice is manifested in the way business partners react to changes of circumstances during the contracting period and performance. In a long-term contractual

relationship it is often more profitable for both of the parties that the cooperation continues rather than terminates. If an unexpected change of circumstances threatens the continuity of the relationship, the partners prefer renegotiations. Especially if neither of the parties is at fault, the partners are ready to compromise and share the losses. Afterwards the amendments may be added into the contract. The parties try to react to the changes of circumstances as soon as possible in order to give the other party enough time to respond to the change. Immediate notification is a preventive measure to minimize losses. Stopping cooperation, or discharging contracts are rarely used, because they may have harmful impact on the future business.

Common goals in a long-term contract relationship increase flexibility in contracting practice. Before concluding a contract, parties would continue negotiations until they have common principles, recognize mutual benefits, and share a common vision about the goals of cooperation. The skills and capabilities of the contracting parties increase flexibility. Business partners have adapted to changes of circumstances by developing abilities to deal with them. Important abilities are cooperation and coordination.Trust may also contribute to resolving disputes where the project is under control.

Furthermore, business partners may prepare for changes of circumstances ex ante before concluding the contract and take actions to prevent losses during the contracting period and performance. The respondents took preventive and proactive measures against the changes of circumstances in long-term and project contracts. Proactive measures were for example investments in gathering information about the potential partner and investments in allocating foreseeable risks in the contract clauses. Preventive measures were, for example, immediate reactions to unexpected changes of circumstances. The parties try to react to the changes of circumstances as soon as possible in order to give the other party enough time to respond to the change. Preventive measuresare thus justified as they minimize losses.

5.4. Flexibility vs. formality

The respondents see a tension between rigid and flexible contracts. It is difficult to share a common viewabout the suitable amount of flexibility.Acertain degree of flexibility is needed, but too much flexibility could make the contract lose itsvalue and meaning. Particularly the

lawyers emphasised that flexibility has to be well balanced with certainty. One of them mentioned that inserting certain types of flexibility should not leave room for disputes.

Companies in China are gradually recognizing the importance of contracts in business cooperation, and take contracts and contracting processes quite seriously. Lawyers seem to prefer formal contracts. Contracts are considered not only as a guarantee and protection for business transactions, but also a preventive tool for risk management.Lawyers highlight the importance of sharing risks by inclusive and exact contract clauses and they want the clauses to be complied with if disputes arise. They also want amendments to be added to the contract documents.

Managers also prefer rigid contracts, but they seem to see them in another different perspective from lawyers. For managers a written formal contract works more as a basis for reallocation of risks than as an ex ante risk management device. For example if production technology fails or material costs arise, the contract clauses work as reference points against the changes that can be reevaluated and in accordance to that the duties and liabilities can be shared and prices adjusted.

5.5. Contract law and enforcement in China: complementary role of formal and informal institutions

The respondents seem to rely more on informal enforcement mechanisms than on formal ones in international long-term business relationships. As to formal dispute resolution mechanisms, commercial arbitration was the most common dispute resolution mechanism. Instead, court enforcement was very rarely used and commercial mediation was not practiced at all.Arbitration procedure was considered faster, fairer and more confidential than litigation. In addition, arbitrators were believed to have better standing and expertise than judges. From the respondents especially the managers seemed to rely more on informal enforcement mechanisms than did the lawyers and legal counsels.

The attitudes of the respondents can be understood in the light of institutional theory. China has a unique institutional environment: the modern legal system in China is very young and the formal legal culture is still very thin. Instead, personal relations and connections are

important factors when doing business. Even though Chinese contract law itself is quite advanced, the lack of trust in the impartiality and expertise of the judges has restrained companies' willingness to use court enforcement. This is not, however a negative phenomenon. Unwillingness to go to the court increases incentives to renegotiate and find a cooperative solution. It also increases incentives to comply with the terms of the written contract document so that court enforcement is unnecessary. In addition, distrust in court enforcement induces the parties to use informal enforcement mechanisms.

Chinese contracting culture rests on *Guanxi*. Deep personal relationship seems to be a more important factor than formal rules of contract law in creating trust and confidence in performance between business partners. The respondents mentioned several times mutual trust as an important element of cooperation. According to the respondents cooperation is not started until the company has acquired sufficient information about the trustworthiness of the potential partner.

Good reputation is a valuable asset for a business company to signal its trustworthiness. In relational contracting, contracts are concluded only with trustworthy partners. This creates incentives for the companies to protect their reputation. The desire to protect good reputation strengthens the power of informal enforcement mechanisms. It restrains incentives to opportunism and increases parties' confidence in performance and the willingness to cooperate.

On the other hand, the lack of good reputation can become an obstacle for a foreign firm to start business with Chinese companies. For example a newly started company may not be able to signal its' trustworthiness, because it is not yet known in the field and it has not yet managed to conclude a wide enough nexus of connections. Thus *Guanxi* can become an obstacle to entry.

Good reputation can be an important criterion when searching for a trustworthy and cooperative trading partner. Thus reputation reduces ex ante searching costs. Good reputation also protects transacting partners against contractual hazards due to incomplete contracts. If both parties have good reputation, parties can save negotiating and contracting costs, because they do not need to include safeguards in the contract to protect specific investments against the opposing party's opportunistic behaviour. Good reputation protects also from other

contractual hazards, because reputation strengthens trust between the parties and increases willingness to share private information. Sharing private information makes it possible to increase mutual gains and reduce transaction costs, because the risks can be allocated to the party who can bear them with lower costs.[53]

Moreover, the role of self-enforcement mechanism was also recognized. The interdependency of the parties makes the contract self-enforcing by creating incentives for the parties to avoid the termination of the contract as long as the stream of future quasi rents is greater than short-term gains of a one-time performance. When both of the parties have a lot at stake, they are more willing to give up something and find a compromise. The respondents mentioned several restorative measures to the unforeseen changes of circumstances: immediate notification, helping in difficulties, protecting partner's interests and willingness to share losses.

The status of informal institutions is very strong in China. Especially the managers seem to rely more on informal enforcement mechanisms than the lawyers and legal counsels. Instead, lawyers' and legal counsels seem to be more respectful towards the legal system than managers, and they see that the law gives framework for cooperation. We consider that informal enforcement mechanisms bring flexibility into the long-term contract relationship, because they guarantee the quality of the performance and the continuity of the relationship in unexpected and uncertain changes of circumstances. We thus conclude that informal institutions or mechanisms supplement or complement formal enforcement mechanisms in contract enforcement in China.

6. Concluding remarks

This empirical study concerning flexibility in contract documents and contractual practice in China presents interesting findings. International project business nowadays presents great challenges to managers and lawyers. Flexibility is definitely needed during project implementation for business partners' common targets. However, flexibility has to be

[53] Bergh, Donald *et al.* (2010) "New Frontiers of the Reputation – Performance Relationship: Insights from Multiple Theories", *Journal of Management*, Vol. 36, No. 3, (pp. 620–632).

balanced with certainty, which is also required from business parties. Thus, an important issue is how to balance flexibility with certainty. Managers are likely to consider changes quite normal, and they are ready to deal with them flexibly in contracting practice. Lawyers instead seem to prefer formal contracts and clear rules.

However, effective communication between company managers and lawyers is not a common practice. Lawyers seem to come to the stage too late –when the problems arise. Three reasons may explain why this phenomenon takes place. Firstly, in Chinese traditional culture, litigations and lawyers are not welcome by business parties. Usually parties will first try to solve any dispute with their partners without a third-party. Such tradition may still have its influence. Secondly, managers and lawyers usually do not share the same value towards the same issues. Thus managers may see lawyers as obstacles in their business decision-makings. Thus, within such environment, lawyers are not willing to take imitative to communicate with managers, unless managers come to them. Thirdly, involving lawyers indicates more costs (including monetary cost and time cost). This may make business parties hesitate to communicate with lawyers. Lawyers could have a preventive role in defining the content of contract in order to control the risks ex ante. Managers could rely more on lawyers' expertise if they were better informed about the whole contract project.

The research findings will provide insights both to legal academics and practitioners, and business community. It must be pointed out that the findings are based on a small number of interviews, and thus cannot be generalized. Future research should include a study with a large amount of empirical data. In addition, empirical study on the topic in other countries is encouraged, which will enable us to compare contracting practices of companies in similar industries in different countries.

A practical implication is that managers and lawyers need to adopt a more cooperative attitude towards each other; and should establish more interactive and effective communication channels in order to contribute to the final success of projects. According to the respondents better results could be achieved with better coordination and communication between lawyers and managers. Lawyers should participate in the business operation at an earlier stage in order to get more familiar with the whole project and managers should contemplate the business relationship from a broader perspective and ask for lawyers' and experts' help in good time before any risk has materialized.

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