

To be or not to be: why do transaction partners in construction industry avoid formulating agreements into contract documents?

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Abstract. Designing the construction contracts efficiently and effectively is vital for project success since contracts can not only motivate and regulate behaviours in projects, but also plays a crucial part in managing interfirm relationship. In practice, however, transaction partners in construction industry sometimes avoid formulating all the agreements into contract documents, which is contradictory to common logic. The aim of this research is to prove the existence of such phenomenon and to investigate the reasons for why it happens. Both questionnaire and semi-structured interviews were conducted in construction industry in China for data collection since China provides fertile context to explore the research questions. The questionnaire was used to prove the existence of such phenomenon and the interviews were used to explore the logic behind. The results show that in nearly 50% of the construction projects in China, the phenomenon of the transaction partners deliberately avoid formulating some agreements into contract documents exist. Given explanations as for why this happens include: 1) showing trust towards the other partner, 2) reducing risks in transaction, 3) increasing the possibility of further collaboration in the future, 4) bypassing the contract check in their own legal departments, and 5) preventing other competitor companies in the market from stealing technology through the contract documents. A comprehensive understanding for designing contract documents is generated in this research, which will not only help project managers for project success but also provides insights into drafting contract terms.

1. Introduction

A well-designed contract is very important for inter-firm transactions as contracts serve three vital functions, which include safeguarding specific investments by reducing opportunistic behaviors, coordinating the exchange processes by clarifying expectations for both transaction partners, and providing adaption plans to contingencies with disturbances in the future [1]. A clear contract without ambiguity can not only motivate and regulate collaborative behaviors, reduce risk, but also plays a crucial part in managing interfirm relationships in transactions.

The current studies in contracting theories mainly focus on either how to draft a contract with better structures and its functions on performance and/or inter-firm relationship [2-4], or discussing the interplay between contractual and relational governance [5-7]. However, a hidden assumption behind has been ignored and undiscussed among the current studies. Researchers have taken it for granted and assumed that the transaction partners would put the agreements they have achieved into formal contract documents for sure and try their best to design the contract provisions well since that is supposed to be the best choice for the project success. However, the reality is, there are some occasions the transaction partners would avoid formulating their agreements into formal contract document on purpose. In another word, putting agreements into contract document might not be the best way. No design, under some circumstances, is taken as the best design in practice.

Putting the achieved agreements into formal contract documents makes it traceable, legal and enforceable in the future when things go beyond expectations from either party's understandings. In addition, the costs in terms of both time and money of writing the agreements into formal contract documents is negligible compared to the cost for the partners to reach the agreements. Despite all of these reasons above, however, it still happens in the practice that the transaction partners sometimes choose not to put the agreements into the formal contract documents on purpose in the construction industry in China.

Thus, the aim of this research is to explore the existence of such phenomenon and the reasons behind it. This research is to answer the following research questions: 1) does the phenomenon of transaction partners choose to avoid formulating agreements into formal contract documents exist in the construction projects in China, 2) if it exists, how often will it happen, and 3) why do transaction partners choose to do so?

In order to achieve the research aim and answer the research questions proposed above, the authors have used both questionnaire and interview studies in this research. The data collection has been conducted in construction industry in China as it provides a fertile context to explore the research questions. 215 questionnaires have been collected and 31 interviews have been conducted for this study at the end.

The results show that, the phenomenon of transaction partners choose not to put agreements into formal contract documents exists in 49.8% of construction projects in China. The reasons for why the partners choose to do so include: 1) showing trust towards the other partner, 2) reducing risks in transaction, 3) increasing the possibility of further collaboration in the future, 4) bypassing the contract check in their own legal departments, and 5) preventing other competitor companies in the market from stealing technology through the contract documents.

The main limitation of this study is the sampling and the following concerns of the generalization of its conclusions. Despite these, this research still successfully answers the proposed research questions and fulfills the gaps in the contracting theory by exploring the most undiscussed assumptions for the current studies. A more comprehensive understanding for designing contract documents is generated in this research, which will not only help project managers for project success but also provides insights into drafting contract documents.

2. Literature Review

The studies related to contracting theories could be classified into four categories, including: 1) contract as a governance mechanism and its interplay with relational governance, 2) contract as formal documents with structures, 3) contract breach enforcement after violation, and 4) contract renegotiation [8]. The studies in the first two categories are more related to this study.

2.1. Contract as a governance mechanism and its interplay with relational governance

Most of the studies in this category use Transaction Cost Theory as the theoretical background and assume the transaction partners are possible to make opportunistic behaviors. The studies, in which contract is taken as a governance mechanism, pay more attention on the contract's role in preventing

opportunistic behaviors, safeguarding the transaction partners' investment, and reducing conflict and disputes.

Some empirical studies in this category have proven that contract, as a governance mechanism, has many positive influences on performance in transactions. By analysing data from 111 interfirm alliances, Parkhe [4] proved that contractual governance could reduce the perceptions of opportunistic behaviors from the other party, encourage both of the partners to invest more specific assets into the transaction, thus promote more collaborations in the transaction. Liu, Luo [9] have also demonstrated that contractual governance could restrain opportunism in transaction after analysing 225 paired sample firms in China. They have also found out that performance is improved more significantly when both contract and relational norms are used jointly compared to using them separately. Luo [10] argues that contract provides an institutional framework in the transaction for guiding cooperation after the analysis of 293 IJVs in a dynamic market. Apart from it, they have also concluded that contract could drive IJV performance both independently and interactively by improving the level of cooperation. Thus, they argue that contract and cooperation complements in relation to performance.

These conclusions have also pulled out another popular discussion in the studies where contract is seen as a governance mechanism. Some studies found out that contractual governance and relational governance substitute to each other while others found they are complement to each other. Similar to the conclusions generated by both Liu, Luo [9] and Luo [10], Poppo and Zenger [7] have also found empirical support for this proposition of complementarity by using data from 152 questionnaires in information exchanges. They have discovered that contracts are more customized with high level of relational governance (and vice versa). In addition, the complementarity also exists while generating improvements in exchange performance. Ryall and Sampson [6] used a sample of 52 joint technology development contracts and coding scheme to make empirical comparison of contract document terms in their study. They have found out that a firm's contract are more detailed and more likely to include penalties when the frequency of the number of the deals is higher in the company, no matter it is with the same or different partners.

However, some other studies have found the different results, which lead them to conclude that contractual and relational governances are substitute to each other. Researchers in social contracting argue that relational governance could also function the same as contractual governance to reduce moral hazards in the transactions raised by specific asset investments, difficulties in performance measurement and uncertainties. For example, Macaulay [11] had preliminary findings in this topic, which indicate that contractual governance are not necessary in many cases and can even lead to worse consequences. Only when the gains of using contractual governance, planning and legal sanctions for example, outweigh the cost of using it, transaction partners will choose to use it. In another word, the presence of relational governance will obviate the need for contractual governance (and vice versa). Some other researchers hold the same opinions on this topic. Dyer and Singh [12] argued that the use of informal agreements, which depend on trust and reputation, can supplant the use of formal contracts.

Li, Xie [13] hold a comparative view on this discussion and collected 380 domestic and 200 international buyer-supplier relationship in China to test the relationship between contractual and relational governance. Their study shows that contractual governance and relational governance may be substitutes in domestic buyer-supplier relationships, but they may be complements in international relationships. Huber, Fischer [14] argued that the interplay between contractual and relational governance is dynamic and could change over time triggered by goal fuzziness, goal conflict, and goal misalignment.

In order to explain the different results in the studies related to the interplay between contractual and relational governance, Cao and Lumineau [5] have conducted a literature review study and identified the reasons for why researchers have come to different conclusions on this matter. Three factors have contributed to this, including: 1) the researchers are arguing about different things. Some of them are discussing the use of these two mechanisms while others are discussing their joint impacts on performance. 2) the moderating effects of environment, and 3) the differences in measurement of

concept in these empirical studies. After the meta-analysis from 149 empirical studies in this topic, they proposed that contractual and relational governances are complementary in vertical interorganizational relationships.

2.2. Contract as a formal documents and its structure

Studies that focus on the structures and functions of contract have higher level of agreements compared to the discussion on the interplay of contractual and relational governances. Generating from Transaction Cost theory, the first agreed function of contract is safeguarding/controlling. This function will encourage cooperation between transaction partners and reduce the opportunistic behaviors in transactions, especially by specifying penalties to violations in contract documents. This function of contract is to deal with relationship risk [1]. The second agreed function of contract is coordination, which is to clarify the expectations from both of the transaction partners [15]. This function is to deal with performance risk. The relationship risk could be unique to the transaction while the performance risk is shared among all the transactions. In a word, the first function is to reduce the negative sides in the transaction while the second one is to encourage the positive side. The third agreed function of contract is adaptation [10], which is to deal with risks and uncertainties that are possible to happen in the transactions before the project. Compared to the first two functions of contract, this function has drawn the least attention in the studies in contracting theory.

Researchers in this area are trying to find out the determinants of the completeness and complexity of the contract. In general, three factors are found to be important in determining the structure of the contract in transaction, including: 1) procurement routes, 2) relationship factors, and 3) the characteristics of the transaction [3, 6, 7].

2.3. Theoretical gaps

Most of the studies in this category use Transaction Cost Theory as the theoretical background and assume the transaction partners are possible to make opportunistic behaviors. The studies, in which contract is taken as a governance mechanism, pay more attention on the contract's role in preventing opportunistic behaviors, safeguarding the transaction partners' investment, and reducing conflict and disputes.

3. Research Methodology

In order to achieve the research aim and answer the research questions, both questionnaire and interview are used in this study. Questionnaire is used to answer the first two research questions as questionnaire is better in measuring and describing the phenomenon in the society. Semi-structured interview is used to answer the third research question as this method suits better in answering 'how' and 'why' questions.

Research context, which includes the culture, political, legal and economic system at a specific time, is important for research since it not only decides theory borrowing from previous studies, but also determines the generalization of the conclusions [16, 17]. Thus, contextualization is carefully conducted in this study. The empirical data in this study has been collected in the construction industry in the People's Republic of China (China) due to the following reasons. Firstly, companies prefer to use network-centred strategies than market-centred strategies in China due to the imperfect institutional background and guanxi culture [18]. Secondly, construction projects are among the most complex projects with high uncertainty from contract. Considering both of two reasons, the focused phenomenon in this study is more likely to happen under such context. Thus, construction industry in China provides a fertile environment for exploring research questions for this study. The ethical approvals for both questionnaire and interviews were obtained before the authors proceed the data collection.

In the questionnaire, the respondents are asked whether their company have avoided formulating the achieved agreements in the transactions into formal contract documents on purpose. The questionnaires have been sent out online to middle or higher level of construction project managers to

guarantee that the respondents would have enough information to answer the questions. The whole process for collecting data by questionnaire took one month. 400 questionnaires have been sent out. Finally, 215 informant responded to it, which generated 53.73% response rate. The descriptive characteristics of the respondents in the questionnaire study is shown in the Table 1. 82.8% of the respondents have more than 5 years working experiences in the industry, which contribute to the validity of this study.

The interviews were conducted after the questionnaire study. The authors have contacted the respondents, who said the phenomenon of leaving agreements outside formal contract document on purpose exists in their project and have left the contact email address, in the questionnaire study. Thus, the way of sampling in the interview study is convenient sampling. Semi-structured interviews with a pre-defined list of questions were conducted.

Finally, 31 professionals (28 male and 3 female) in construction industry in China with experience in leaving agreements outside formal contract document on purpose in their project were interviewed. Each of the interview lasted from 20-40 minutes face-to-face and was recorded with the permission from the interviewees. All the interviewees were aware that their answer would be kept confidential and anonymity preserved and used only for academic purposes. The interviews were turned into transcripts. The whole interview study took 3 months in total. The authors stopped the interview until the data saturation has been achieved (Francis et al., 2010).

Open coding, axial coding and selective coding guided by Anselm and Juliet [19] have been conducted in analysing qualitative data collected by interviews.

Table 1. The descriptive characteristics of the respondents in the questionnaire study.

Characteristics of the respondents		Number	Percentage (%)
Working Experience	Longer than 10 years	78	36.3
	5 to 10 years	100	46.5
	Less than 5 years	37	17.2
Position	Project Manager	73	34.0
	Department Manager	73	34.0
	Manager in Parent Company	48	22.3
	Others	21	9.7
Duration for the Project	Less than 1 year	38	17.7
	1-3 years	130	60.5
	Longer than 3 years	47	21.8

4. Findings and Discussion

From the questionnaire study, the authors found out that among the 215 collected questionnaires, there are 107 questionnaires, in which the respondents choose the option with the statement that There are some occasions we will choose to leave the achieved agreements out of formal contract document on purpose. In another word, in 49.8% of the construction projects in China, the phenomenon of leaving the agreements out of formal contract documents on purpose exist. The result is shown in the Table 2.

Table 2. The result of questionnaire study.

	Number	Percentage (%)
We put all the agreements into formal contract documents without any exceptions.	108	50.2
There are some occasions we will choose to leave the achieved agreements out of formal contract document on purpose.	107	49.8

After proving the existence and estimating the frequency of the phenomenon, the authors conducted open coding, axial coding and selective coding accordingly based on the qualitative data collected by the interview study. Open coding is firstly conducted after reading through the interviews transcripts. Axial coding is then conducted by finding connections between codes. Selective coding is conducted at the end by bringing all the codes together with one overarching category. The results of each of the coding processes are shown below in the Figure 1.

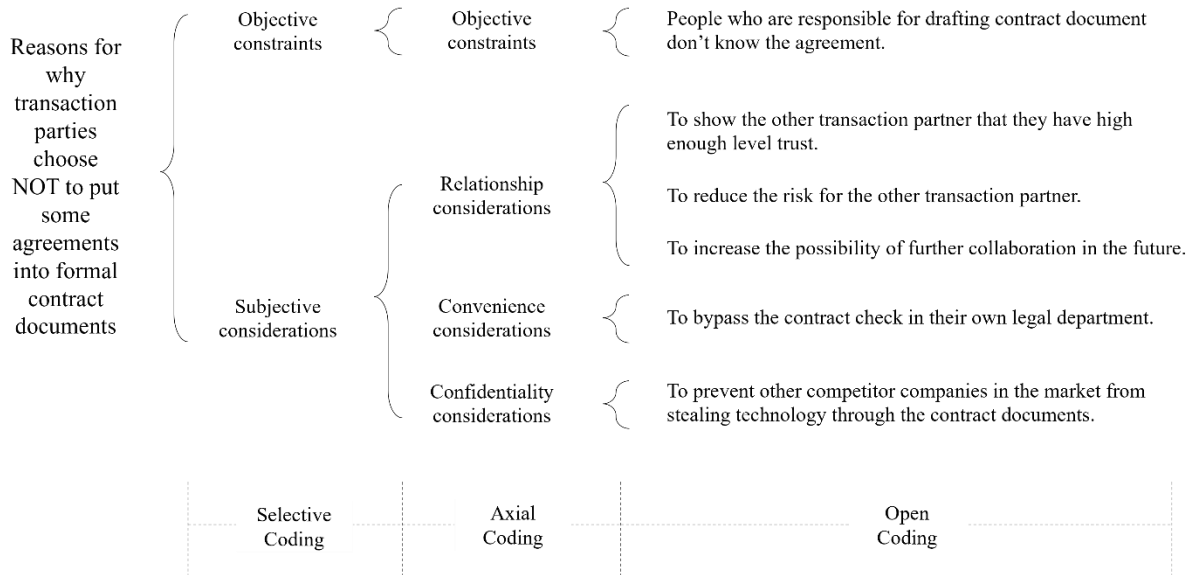


Figure 1. The coding results from interview transcripts.

From the interview transcripts, the author found out that sometimes the transaction partners avoid formulating the agreements into formal contract document because of objective constraints. For big companies, the people who are responsible for drafting contract documents are different from those who are responsible for negotiating with the other transaction partner. It will sometime cause the communication failure, thus leaving some agreements out of formal contract documents. However, this is not what this study is interested in as the authors are trying to figure out why some agreements are left out of the formal contract documents by transaction partners on purpose, not just by accidents due to miscommunication.

The results from the interview in this study show that many subjective considerations would cause the transaction partners leave the agreements out of formal contract documents on purpose. The first category is relationship considerations. Same as the conclusions in the study from Macaulay [11], this study finds out that contractual governance is not necessary in some cases. Considering the status of relationship between the transaction partners, one party would choose not to use contractual governance just to show their trust toward the other party. The whole process is dynamic as well, which is the same as stated by Huber, Fischer [14]. As proposed by Dyer and Singh [12], the use of

informal agreements depending on trust and reputation, can supplant the use of formal contracts. This study has supplanted this argument. The reduce of the use of formal contracts could also at least keep the level of trust between the transaction partners. What the authors want to emphasize here is that, the interviewees said in the interviews that they choose not to put agreements into formal contract document is for showing the other partner they trust them. However, they didn't say whether the trust would be damaged if they choose to do so. Thus, the authors argue that the opposite side of reducing the level of trust is not necessarily increasing the level of trust. It might also be keeping the current level of trust without damaging it. They might also choose to leave the agreements out of formal contract documents for reducing the risk for the other party, and increase the possibility of further collaboration in the future, which is the same as the conclusion from Cao and Lumineau [5].

The second category of the subjective consideration is more interesting. The reason for why the transaction party chooses not to put the agreements into the formal contract document is to bypass their own company's legal check from the legal department. This one is surprising for the authors as the result reveals that the transaction party has closer relationship with the other transaction party outside their own company compared to the relationship inside the organization between the contract drafting department and the legal checking department. As mentioned by one interviewee, 'as a contractor, we sometimes have to build small buildings for our client in order to get the mega project bid. We can't write it into the contract document as it will not pass the legal check in our own department since it doesn't meet the company's requirements. Clients understand our situation and trust us that we will keep the promise. Thus, we decide to leave the agreement outside the formal contract documents'. The level of trust also works in this scenario. The high enough level of trust provides a foundation for the transaction partners to choose to leave the agreements outside the formal contract documents if they need to do so.

The third category of the subjective consideration is to prevent other competitor companies in the market from stealing technology through the contract documents. This is more often when the transaction party feels that the possibility of contract violation in the transaction is high even before they sign the contract. When the transaction partners need to go to legal court to solve the disputes or contract violations, the signed contract documents would be public under some cases. The companies thus choose to leave the core technological details out of the formal contract documents for the considerations of confidentiality in case they have to make the contract documents public in the future requested by legal court.

This study has contributed to the current contracting theory by proving that the phenomenon of transaction partners choose to leave the agreements outside the formal contract documents on purpose exist in practice and providing the reasons for why they choose to do so. In addition, this study has also provided more insights on how does trust and contractual governance interplay with each other in dynamic ways. Apart from these, this study has many implications for the construction industry in China, and for those who want to conduct business under similar culture to China, with attentions highly paid to relationship and weak legal enforcement system. Firstly, the companies should know that it is possible for the transaction partners to leave the agreements, which they have achieved with long time on discussion, out of the formal contract documents. Secondly, no design might be the best design for the transaction under some circumstances. Thirdly, trust is important for the transaction in many different ways. Transaction partners should try to build trust between each other. Last but not the least, good communication is important in contract drafting in order to maker sure all the agreements have been put into contract documents. The legal department should also be more flexible in order to include all the achieved agreements into formal contract documents.

5. Conclusions and Further Research

After analysing the data from 215 questionnaires and 31 interviews in the construction industry in China, the authors generate the following conclusions. The phenomenon of leaving the agreements out of formal contract documents on purpose exists in nearly 50% of the construction projects in China. The reasons for why it happens include five subjective considerations: 1) showing trust towards

the other transaction partner, 2) reducing risks in transaction, 3) increasing the possibility of further collaboration in the future, 4) bypassing the contract check in their own legal departments, and 5) preventing other competitor companies in the market from stealing technology through the contract documents.

Apart from this, the authors found out that sometime the objective constraints due to the lack of communications can also cause the transaction partners leave the agreements out of formal contract documents by accidents, especially when the people who are responsible for drafting contract are different from those who are responsible for negotiating with the transaction partner in the frontline. Good communication should be conducted within the organization between contract negotiating and contract drafting. The legal department should also be more flexible to avoid pushing their own people to the other organization.

Though this study has both contributed to contracting theory and provided practical implications for the construction industry, it still has many limitations. Firstly, this study only focuses on whether the phenomena exists without further discussing what kind of agreements and/or provisions would be left out of formal contract documents. The studies in the future could investigate the features of those agreements. Secondly, this study finds out that the transaction partners sometimes choose not to put the agreements into formal contract documents. During the interviews, some interviewees have mentioned the difficulties of dealing with agreement violation later in the transaction. The studies in the future could investigate how do transaction partners deal with such situation. Thirdly, the sampling of this study has been conducted in construction industry in China. This has limited the generalization of the conclusions. The studies in the future could explore the same phenomena under different contexts and jurisdictions in other countries.

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