

# Flexibility in Contracting

*Nystén-Haarala Soili, Barton Thomas D., Kujala Jaakko (eds.)*

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# FLEXIBILITY IN CONTRACTING: INTRODUCTION<sup>©</sup>

By Thomas D. Barton \*

“Flexibility” in contracting is typically conceived from two quite different, and seemingly opposed, perspectives. For those who approach contracts from a legal perspective, flexibility is regarded suspiciously: It threatens to undermine some foundational assumptions about why contracts are made and the role of the law in safeguarding those purposes. But for those who approach contracts from a more business-oriented perspective, especially the longer term agreements that typify modern supply contracts and complex projects, flexibility is viewed as an essential ingredient for success. Modern business relationships can scarcely function without parties being able to accommodate themselves to inevitable changes during the lifetime of the contract.

The two groups have not always communicated well. Too often their dialogue may have resembled the imagined conversation that begins the first Chapter in this book (*Flexibility and Stability in Contracts*, by Thomas D. Barton, Helena Haapio, and Tatiana Borisova). In that fanciful conversation, the beginning assumptions of the two speakers diverge so powerfully concerning the purposes and functions of contracts that it is difficult for the speakers to find common ground. In reality, the stand-off between the two perspectives are contracts that are *drafted* by lawyers—largely attempting to suppress flexibility—but that are *implemented* by business parties, who attempt to find ways to smuggle in more flexible arrangements. The lawyer-drafted written agreement may contain a variety of conditions, promises, and stipulated remedies that seek predictability and control. But the implementing business parties routinely avoid resorting to formal legal procedures to enforce their rights; they prefer to negotiate an accommodation that continues the deal and the underlying commercial relationships.

This friction between the legal/certainty/control perspective and the business/flexibility/accommodation perspective has endured for many years. Parties routinely

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\* Louis and Hermione Professor of Law, California Western School of Law, San Diego, California

invest considerable time and money in creating a contract that seeks to specify precise legal rights, duties, and remedies, but then avoid using those rights—resorting to them as a last alternative.

Perhaps this syndrome of parties equipping themselves with legal rights, but then often behaving as though those rights do not exist, is economically efficient. Perhaps without the clarity of the legally-based contract provisions, the parties would not have a common platform from which even to begin negotiations in the event of a dispute. So the clash of the two perspectives toward flexibility in contracting may, paradoxically, contribute to a healthy, efficient system when the two perspectives are kept in reasonable balance. But we cannot help but wonder: how much *more* efficient and functional might contracts be if *both* perspectives were acknowledged and appropriately included in the written contract itself? And, if both perspectives *were* to be written into the agreement, what would such clauses say?

We cannot answer these questions without empirical investigation of specific contract and project applications, and without interviewing the lawyers and business parties involved in modern contracting. That need was the impetus for the formation of the multi-national, multi-disciplinary study group that was formed through the generous support of the Finnish Cultural Foundation and led by Professor Soili Nystén-Haarala. Over a two-year period, Professor Nystén-Haarala periodically convened a group of lawyers and scholars from several countries in Europe, the United Kingdom, Russia, Asia, and the USA. Their collective task was to consider and study the idea of flexibility of contracts. Participants from different countries were encouraged to collaborate, so as to open up the original perspectives from which they first approached the idea of contractual flexibility. Some undertook interview projects, some designed empirical surveys, and some approached the questions analytically rather than empirically.

The results were surprising, but highly enlightening and suggestive of the need for much more study of these issues. First, not everyone interpreted alike the meaning of the concept “flexibility.” Second, some people reported on legal, economic, social, or psychological barriers to greater flexibility. But third, some found the opposite: ways in which the law or even language may actually promote flexibility in the operation or interpretation of contracts.

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Perhaps these disparate meanings and findings were inevitable, given the reality of the long-standing struggle for supremacy between the two basic perspectives toward contract flexibility. Both perspectives reflect legitimate economic and psychological principles and needs. Furthermore, the work of the study group demonstrates that attitudes to flexibility in contracting reflect different cultural and professional backgrounds and values. Relatively informal contracting behavior emphasizing loyalty may be normative in Finland; reinterpreted and embraced as traditional *guanxi* in China; viewed as risky and idealistic in the individualistic U.S.A; and theoretically desirable but bureaucratically almost impossible in Russia.

In the end, each Chapter in this book may be viewed as contributing to an understanding of both flexibility and stability in contracts: why each is important, and how both may be achieved simultaneously. Solutions may be advanced in a number of different ways. They may appear inside the contracts themselves, through better design and through clauses that mandate stronger collaboration between the parties. Solutions may also be achieved through better communication between those who draft contracts and those who perform them, as in complex projects or supply contracts. Flexibility with stability may also be furthered through simplifying national or EU laws, so as to enable more party autonomy; or through its opposite: developing or liberalizing the infrastructure of contract law in countries like China or Russia. Different methods for packaging or transferring contracts can also help, as in movements toward marketing “branded” contracts or traditional assignment of contract rights to third parties. Finally, a blended combination of flexibility and stability has been found through interpreting the meanings of words themselves.

The first chapter, *Flexibility and Stability*, was introduced above. It imagines a dialogue between holders of the clashing perspectives about flexibility; the chapter then acknowledges the legitimacy of each perspective, and offers recommendations for promoting better communication and contract functionality through visualization and collaboration.

Following that overview, *Flexible Contracting in Software Project Business: What We Can Learn from Agile Methods in the Software Industry* by Jouko Nuottila, Jaakko Kujala, and Soili Nystén-Haarala offers a closer look at these tensions in the context of project management. Project management entails ongoing decision-making—sometimes hundreds of decisions—during the course of completing a substantial project. This chapter first introduces

the evolution of models that are used to understand the dynamics of successful project development. It then suggests the implications of that evolution for both project management and the legal contracts that accompany projects. A contract created at the outset of a complex project cannot realistically specify responses to the many contingencies that may arise. Successful contracts must create a framework that is stable enough to respect overall expectations, but flexible enough to work pragmatically. Employing interviews with software executives and technical personnel, this chapter examines how to achieve that balance, emphasizing the importance of trust and cooperation among project partners in implementing an agile approach to project development.

In the third chapter, *Flexibility in Contracts and Contractual Practice: Empirical Study in China*, Yanan Zhang and Riitta Ahtonen begin by pointing us toward economic theories that are useful in analyzing flexibility in contracting. That theory informs the design of an empirical study undertaken in China, through interviews of both lawyers and managers operating inside homegrown Chinese companies and also in China divisions of European companies. The collected results constitute a snapshot of one moment in the thoughtful commercial development of a nation. In that picture, we can find room for optimism: that most lawyers and business managers intuit the need for balancing clarity and legal rules with the maintenance of personal relationships. We see also a government exploring what practices may be best received within Chinese traditions, but simultaneously enable a future tied to international trade.

Not every legal initiative, however, constructively promotes either flexibility or stability. Sometimes either the laws themselves or the people administering those laws can stifle innovation or efforts to incorporate particular rules to guide particular commercial relationships. For example, Hans-Werner Moritz and Maximilian Kuhn in *Legal Implications of Flexibility in Business Contracting from the German Perspective* suggest that both German national laws and various EU initiatives actually constrain traditional freedom of contract and flexibility through limiting the use of choice of law clauses. And in *The Interplay of Flexibility and Rigidity in Russian Business Contracting: The Formal and Informal Framework in Contracting* by Soili Nystén-Haarala, Elena Bogdanova, Alexander Kondakov, and Olga Makarova, the authors remind us that regulations will always be enforced by judicial or executive branch officials who exercise discretion. Those officials may see their roles as facilitating business arrangements, using their discretion wisely to intervene where

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one party may be unfairly exploitative of the other. But conversely, those same officials may come to see their discretion as an opportunity to wield power with ego-boosting arbitrariness. Even worse, enforcement officials may be corrupt, extracting bribes to overlook regulations that might otherwise stifle commercial dealings.

As *The Interplay of Flexibility and Rigidity in Russian Business Contracting* chapter underscores, contracting as well as the law in general will be influenced by the social environment in which it operates. Even more broadly, linguistic and cultural traditions frame basic understandings of the meanings of laws: both the words themselves and the nature of human interaction. Flexibility flows inherently from different languages—even where one might expect that legal professionals speak a certain common language, given their similar professional training and exposure to fundamental legal concepts. Not all lawyers mean the same thing when addressing the same words or concepts, which can introduce either a healthy flexibility, or confusion and mistrust. That point is expertly documented in the multi-national comparison of *Achieving Flexibility in Contracting by Using Vague Terms in International Business Contracts: A Comparative Approach from the Perspective of Common Law, German, Polish, and Chinese Law*, by Joanna Grzybek, Tina de Vries, and Yanan Zhang.

The inherent flexibility of language is complemented in international contracting by cultural differences that bring contrasting attitudes about trust, loyalty, and the importance of human relationships in commercial dealings. These underlying social and moral expectations about people are explored in two chapters: Petra Sund-Norrgård, Antti Kolehmainen, and Onerva-Aulikki Suhonen in *The Principle of Loyalty and Flexibility in Contracts*; and Taina Savolainen and Mirjami Ikonen, *Trust as Intellectual Capital in Pursuing Flexibility in Business Contracting*. *The Principle of Loyalty* suggests that if human relational norms are widely understood and accepted within a culture, the judiciary may override explicit contract language to the contrary. Doing so, paradoxically, may actually stabilize contracting relationships by bringing in tacitly understood norms that cannot be overridden by contract disclaimers. So also with *Trust as Intellectual Capital*: the authors explore the concept of trust among parties to a contract as a non-legal device to find a balance between the perspectives of control and flexibility.



Sometimes the parties to a transaction can find needed flexibility or system stability through third parties, rather than through their own interactions or contract language. The simple devices of extending credit instead of demanding immediate payment; or permitting a party to liquidate a long-term resource or periodic stream of income; or to delegate a duty that has become onerous to a third party, all can bring enormous flexibility into commercial dealings. In *Flexibility in Assignment of Contractual Rights: Assignment of Account Receivables*, Lingyun Gao reminds us of the rich history and usefulness of these devices. She describes legal vehicles for obtaining commercial financing through third parties, and analyzes their reception in modern Chinese law. Such third-party, post-contract devices must be taken into account when attempting to understand and assess the overall flexibility of a contracting system.

The book concludes with *Promoting Contract Flexibility through Trademarks: 'Branded' Intellectual Property Licensing Practices*, by Nari Lee and Thomas D. Barton. This chapter points toward a possible future source of flexibility: development of alternative contracts for licenses or other transactions that are created and sold under what may become familiar brand names, as one would buy soap powder. Flexibility in the contracting relationship would be through the marketplace itself—and the alternative substantive terms that could be represented in the competing brands of contracts. Such flexibility may also offer stability to the system, by democratizing contract formation. In a world of increasing standardization of contracts and decreasing comprehension of those agreements—especially by consumers who may “click through” the “I agree” buttons of a contract without reading a word of the terms—the ability to rely on, and demand, a trusted name in contracting may bring into better balance the bargaining power between one-off purchasing consumers and the far more sophisticated companies that draft and replicate standardized agreements for those consumers to sign.

This book arrives at a significant historical moment. As the importance of contracting grows in a globalized economy that relies increasingly on human connection rather than national power, designing a contracting system that is flexible, stable, and fair becomes paramount. The entire study group wishes to express our gratitude to the Finnish Cultural Foundation for enabling its work; to Soili Nystén-Haarala for her insight and effective leadership; and to Yanan Zhang for her competent and friendly style in organizing events and paper submission. We are delighted to share the results of our study and encourage the reader's communication

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with authors in particular, or the co-editors of the articles in this issue of the LAPLAND LAW  
REVIEW: Soili Nystén-Haarala, Thomas D. Barton, and Jaakko Kujala.

# Flexibility and Stability in Contracts<sup>©</sup>

THOMAS D. BARTON,<sup>1</sup> HELENA HAAPIO,<sup>2</sup> TATIANA BORISOVA<sup>3</sup>

“Flexibility” and “stability” can have strongly diverging relationships in the minds of those who deal with commercial contracts. For some, flexibility *fight*s stability. “Flexibility” in their minds is synonymous with confusion, inefficiency, disruption, and lawsuits—and therefore with higher costs and lesser profits. For others, however, flexibility is a *source* of stability, prompting communications that lead to broader understanding of needs, capabilities, opportunities, and trust.

Both perspectives are understandable, and each may be valid. The wrong sort of flexibility in a contract may lead to higher costs and frustration; the right sort of flexibility may enable better commercial relationships. The goal is to find ways to enhance positive flexibility, without introducing disruption and potentially extortionate renegotiation of contract terms. The first step toward providing stronger flexibility *together with* stronger stability is to consider flexibility (and contracts generally) not exclusively in legal terms, but instead as patterns of communications among various people involved in commercial exchange.

This article explores *collaboration* and *visualization* as promising tools for enhancing contract flexibility even while enhancing stability. Better collaboration seeks stronger communication among the contracting parties, their lawyers, and those who will implement the contract. The flexibility introduced could rebalance and better integrate the commercial, personal, and business relationships that comprise a contract. Visualization techniques enable those stronger communication patterns. By using graphic images in the various documents that comprise and support contracting, the *process* of creating those documents becomes more inclusive. Furthermore, the *substance* of contracting goals, terms, and underlying assumptions becomes more transparent and usable to broader segments of the commercial community.

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<sup>1</sup> Louis and Hermione Brown Professor of Law, California Western School of Law, San Diego, California, USA

<sup>2</sup> Postdoctoral Researcher, University of Vaasa; Legal Management Consultant, Lexpert Ltd, Helsinki, Finland

<sup>3</sup> Associate Professor, Department of History, National Research University Higher School of Economics (HSE), St. Petersburg, Russia

## 1. Introduction

Imagine two business people having a conversation about contracts. Chris begins by saying, “I do not understand this idea of bringing flexibility to contracts. The whole notion seems contradictory. For me, the point of making a contract is to bring predictability to a future that seems full of uncertainty and risk. If I want my business to change along with circumstances, why should I make a contract in the first place?”

Kim replies, “In my business, contracts are not necessarily about trying to lock in some vision of the future. Whatever vision I can imagine right now is likely to be incomplete or even wrong. And so if I create some artificial permanency, think of all the opportunities I will have lost if I cannot adapt to the changes I did not anticipate. I need to invest in commercial relationships: to build networks of contracting partners who I can trust and grow with. I can do that best by making contracts now that are flexible and collaborative.”

“But how can you count on making a profit with an arrangement like that,” responds Chris. “How can you possibly set a price in the contract if you don’t know what your duties will be? And how can your production or delivery teams know how to plan and implement their responsibilities if the contract isn’t clear?”

“I am not talking about making contracts that are ambiguous or incomplete,” says Kim. “I agree that the wrong kind of ‘flexibility’ can lead to instability or confusion, and therefore higher transaction costs and quality control problems. I don’t want to abandon clarity; not at all. I want contracts to be *more* clear, and to more people. I want to understand my contracts thoroughly, and I want all of my engineers and sales people to understand them as well. Like you, I don’t want ambiguity either in language or legal rights; but I *do* want contracts that are flexible in positive ways.”

Kim continues, “I want my contracts to be resilient to challenges, and to enable me to seize opportunities as they come along. I want my contracts to help me identify how I can improve my product, my service, and my strategic planning. If my contracts set up the right sort of ongoing communication, internally and externally, I can get the sort of information I need for quality control and potential innovation. Getting my contracting partners to supply this

feedback is far more realistic and honest than trying to foresee the future.

“No way,” says Chris. “You are just asking for trouble. Once we get a contract signed, I want to put it in a drawer and forget about it. The best contract is one we never have to read or even hear about. After it is made, a contract is just a fail-safe for the lawyers if we get sued. Talking about a contract while it is being implemented—especially inviting feedback from the other party—just invites whining. Or even worse, it opens me up to exploitation. There is no profit in listening to problems—if I invite that, our buyers will just want us to shave prices. So I tell my lawyer, ‘make sure that litigation will not hurt us. Shift every risk we can to the other side, and make sure to include any disclaimers or other protections the law can give me. Make contracts as tough and absolute as we can get away with. That way, people will know they can’t mess with us.’ I need bulletproof legal protection and I expect my lawyer to provide it.”

“My contractual counterparts are spread across the globe,” says Kim. “I cannot trust that the law will really be that certain in resolving our contract disputes, no matter how strongly we try to write the contract. We cannot always predict what the applicable law will be, nor what that law will specify once we determine which law will govern. And even if we can manage to prevail legally, trying to enforce a judgment in a foreign country is an expensive nightmare. Worse, at the end of an unreliable effort toward legal solution, we might be left with a terminated contract and poisoned relationships.”

Kim continues: “My contracts are often interdependent. I cannot afford to view any contract in complete isolation. I need webs of exchange that can expand and shrink as new opportunities arise, maybe even in the middle of implementing an initial contract. So I would not want to sue a counterpart over most disagreements, just to achieve some short-term gain or personal vindication. If circumstances change—which we fully expect and hope to steer in a way that is profitable for us—then we will adapt to whatever reasonable needs of our contractual partners that can help make this happen. I need for my lawyer to design something that does not get in the way of what I want to accomplish by artificially freezing the future, or turning my counterparts into antagonists the first time a problem arises. I need a contract that is open-minded about changed circumstances, and one that alerts me well in advance of needed adjustments.”

“Sorry,” concludes Chris, “you just don’t live in the real world.”

Which speaker is right? The first speaker’s (Chris’) concerns about flexibility seem familiar and somehow prudent. But the second speaker’s (Kim’s) goals also seem plausible, even if untraditional, and in the long run perhaps more productive. Can both speakers be “right,” at some level? *If so--if both perspectives are legitimate--could we craft contracts that satisfy both speakers?*

We believe that each speaker presents a point of view that must be taken seriously—legally, economically, and psychologically. Although we clearly favor the approach of Kim, the views of Chris are heartfelt and will not change overnight. We believe that contracts will not realize their full potential for generating value until both perspectives are better understood, and taken into account in the design of contract processes and documents. For example, does Chris really want “inflexibility” as such? Is that the real interest of business people, or is the real interest something deeper? Does Chris seem to demand rigidity only because “flexibility” shows up as synonymous with confusion, inefficiency, disruption, and lawsuits—and therefore with higher costs and lesser profits?

What if we were able, *without causing any of those costly disruptions*, to find a way to provide the positive sort of flexibility that Kim wants: flexibility that prompts communications that are clear, transparent, comprehensible, and participatory, and that lead to broad understanding of needs, capabilities, opportunities, and trust. Would Chris still resist? Most business people want relationships that are more flexible. In a poll taken among the members of the International Association for Contract and Commercial Management (IACCM), nearly 90% said that “flexibility and greater agility” are important for their contracts.<sup>4</sup> Managers also want (at least sometimes) relationships that are more trusting and personal.<sup>5</sup>

Such data reveal that “flexibility versus inflexibility” is not the underlying issue. The basic task is to create contracts that provide frameworks by which businesses can realize the best

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<sup>4</sup> IACCM Poll (2011) <http://contract-matters.com/2011/09/21/stuck-in-a-negotiation-rut/>, last visited August 18, 2014.

<sup>5</sup> Macaulay, Stewart (2004) “Freedom from Contract: Solutions in Search of a Problem?” 2004 *Wisconsin Law Review* 777, at pp. 790–795.

possible exchange and relationships, and which enable the strongest growth and innovation. Lawyers and others who construct contract documents and processes should realize that *some* sources of flexibility are undesirable: they are antagonist to achieving basic economic and strategic goals. Drafting contracts ambiguously, so that the parties cannot understand their rights and responsibilities, leads to the sort of disruption and disputation which Chris fears. *Other* sources of flexibility, however, actually *promote* economic and strategic goals. Initial entitlements, roles, and requirements must be clear. If they are not, then trouble will predictably arise, slowing down deliveries and payments and endangering relationships and trust. If a dispute arises, any negotiation about the dispute will be made more difficult because the parties will not know who must buy out whom.<sup>6</sup>

We should not think of flexibility in contracts exclusively in *legal* terms. That is primarily how Chris thinks of flexibility: “I either have my rights, or I don’t; any source of ‘flexibility’ endangers my rights.” But flexibility in contracting can be better understood as Kim does: as *patterns of communications* among various people that could be more diverse and enabling. Making legal rights fuzzy is not flexibility; it is just confusion and an invitation to start arguments. Opening out understanding and communication among all those who work with and through contracts is positive flexibility.

Contracts designers need to develop processes and documents that imagine goals beyond securing legal rights and duties, even while they do not lessen basic security. Lawyers and other contract crafters must be open to the possibility that if they focus *exclusively* on legal rules, they will not see the potential for positive flexibility.

## 2. The Role of Lawyers

We are not alone in calling for lawyers to be more mindful of the prospects for positive flexibility in contracting, and to be more supportive of the broader understanding of contracting that is represented by Kim. George Dent, for example, writes about the emergence of new kinds of contracts and strategic alliances, and how each of those

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<sup>6</sup> Calabresi, Guido and Melamed, A. Douglas (1972) “Property Rules, Liability Rules, and Inalienability: One View of the Cathedral”, 85 *Harvard Law Review* 1089, at pp. 1093–1096.

movements suggests the need for greater collaboration and contract flexibility. Lawyers should, says Dent, become “enterprise architects.”<sup>7</sup> He identifies the futility of relying on legal liability to ensure compliance, for example, in contracts for the sale of goods or services:

Many ...deals entail a requirement or expectation of extensive future dealings. Even in a single sale of goods the parties must often collaborate on delivery, installation, operation, and maintenance after the closing. Further, the parties often envision future intercourse between themselves (sometimes formalized in a long-term or “relational” contract) and with others, so they want to establish trust and cooperation and burnish their reputations.

In contracts for services (which now comprise most economic activity), collaboration is even more important. The services rendered and the cooperation needed are often so complex that contract terms can only vaguely sketch the parties' duties. Proving a breach in court, then, may be impossible absent flagrant misconduct, so that litigation is of little value in enforcing reasonable expectations. In many service and long-term sales contracts, the parties also expect to modify terms before the agreement expires. Given the impossibility of drafting and enforcing precise performance obligations, the parties often employ indirect solutions, like fair and efficient exit and termination arrangements.<sup>8</sup>

As with service contracts, strategic alliances also flourish through better understanding, collaboration, and adaptability. Dent identifies the need for structures that enable that flexibility. He also identifies, however, the challenge of avoiding the unnecessary costs, frustration, resentment, and possible opportunism when contracts are unclear about the rights and duties of the parties:

In joint ventures and other strategic alliances (such as licenses, dealerships, and franchises), the parties' collaboration after the closing is the whole purpose of the deal. Written terms, then, are even less useful than in service and long-term sales contracts. A writing can fix some measurable ancillary duties, such as how much money a party will contribute and what personnel it will second to the venture. The primary duty, however, cannot be precisely defined; it must often be described in such vague terms as “best efforts.”

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<sup>7</sup> Dent, George W. (2009) “Business Lawyers as Enterprise Architects”, 64 *Business Lawyer* 279.

<sup>8</sup> *Id.*, at pp. 289–290.



The limited utility of the writing does not mean, however, that drafting is easier or less important or that the lawyers' role is less significant--quite the contrary. ...

Alliances often last for many years. In setting the scope of the venture, the parties do not want a fixed plan but flexibility to handle unexpected contingencies. If a venture is defined too broadly, it could include activity that a partner could pursue (more) profitably alone or with a third party. If it is too narrow, one party may appropriate the knowhow of its partner, hence denying the partner the fruits of its efforts. Vague contract terms may preserve flexibility but foster uncertainty about who owns opportunities that arise out of the venture or that come to one partner from an outsider. Parties in an alliance often start small and see what happens; if the venture prospers, they expand it. Lawyers must craft a structure to suit the alliance through various stages or, at least, not pose undue difficulties when modification of the venture is needed.<sup>9</sup>

The needs for positive flexibility are not confined to contracts for the sales of goods or services, or to strategic alliances. In their study of lawyer practice in the "Silicon Valley" centered in Palo Alto, California, legal historian Lawrence Friedman and others identify how successful lawyers draft contracts that are better suited to the evolving needs of their clients:

*Congruence of Legal and Business Styles.* The claim that the legal style of [Silicon Valley] practitioners suits the clients' styles of doing business is one of the most intriguing, if also one of the hardest to pin down. We have been told by some local lawyers, for example, that the typical venture financing document is shorter than its New York City counterparts.... Its language is more general. It does not try to spell out contingency plans for every conceivable event that could go wrong, but assumes that the parties will be able to cooperate sufficiently to work out flexible adjustments to changing circumstances. Such deals have the 'high-trust' or 'relational' character that sociologists of law and business attribute to communities of traders or firms engaged in long-term ongoing relations.<sup>10</sup>

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<sup>9</sup> Id., at pp. 290–291.

<sup>10</sup> Friedman, Lawrence M., Gordon, Robert W., Pirie, Sophie, and Whately, Edwin (1989) "Law, Lawyers, and Legal Practice in Silicon Valley: A Preliminary Report", 64 *Indiana Law Journal* 555, at p. 563.

More generally, Friedman, et.al. describe the strongly pragmatic approach of these lawyers, and the two-way communications that enable a style of lawyering that the authors dub “Facilitative Law”:

*Facilitative Law.* The Silicon Valley lawyer not only works with engineers, he thinks of himself as a kind of engineer—a legal engineer. His job is not just counseling or advising on what the law is; his job is to solve problems: to take a principle, a task and ‘engineer’ it legally, showing how it can be done, or be done best. It is not his job to say something can't be done, but to show how it *can* be done. In his view, the New York or Boston lawyer lacks this facility, this attitude, or has it to a lesser degree...

[Quoting one of these lawyers:] “I think the most interesting legal problems are the ones where a client comes in with a new technology or a new problem and there is no form book to go and change the dates and names. You really have to stare at the ceiling and say, ‘Gee, if I were in this business, what would be the asset I would want to protect, and how would I commercialize it, and what would have to be the legal form of protection, and what would the documents have to look like, so that commerce wouldn't be impeded every time you wanted to make a sale?’ . . .”<sup>11</sup>

The metaphors employed by Dent (“enterprise architects”) and Friedman (“engineers”) to describe the activist role of these lawyers are consistent with our emphasis on the need to *design* for positive flexibility. Lawyers must consciously imagine contract structures that will promote full understanding of the purposes and provisions of a contract, and that will put the right people together for the right sorts of conversations and feedback. Lawyers as proactive designers will find ways to promote understanding and productive communication. Those are the qualities that will advance positive flexibility without bringing in the effects of negative flexibility.

Chris above concluded the fanciful conversation at the outset of this chapter by accusing Kim of not living in the “real world.” For a growing number of observers, however, the real world is moving in Kim’s direction. New attitudes are unfolding about the relationship between legal frameworks and business methods and goals. More and more, legal frameworks will be judged by their effectiveness in facilitating and guiding business cooperation rather than as

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<sup>11</sup> Id., at pp. 562–563.

mere formal expressions or memorials of past business decisions.

In the sections below, two methods are highlighted for advancing positive flexibility. The first is “collaborative contracting” which promotes communication, cooperation, and trust between the parties to a contract, but also between the parties and the lawyers who may be responsible for its drafting or negotiation. The second is “visualization,” which strongly promotes both clarity and understanding among all those who are affected by a contract. Both collaboration and visualization are important to achieving positive flexibility. All of the people who participate in contracting must communicate better with one another, at each stage of the contracting process. But fully understanding both the goals of the contract and the particulars of responsibilities under the contract are preconditions for those communications being positive and productive.

### 3. Collaboration

The emphasis on collaboration—among the parties to the contract, between the lawyer and business client, and within the various functions and departments of a company that must plan, craft, negotiate, and implement contracts—reflects the need to reverse some historical trends. Those trends are most visible if one views contracts not as mere documents, and not as isolated transactions. If one instead sees contracting as comprised of three relationships—an exchange relationship, a set of personal relationships, and a legal relationship—then two patterns emerge.

The first pattern is that the three relationships seem less connected now than they were in an earlier era and simpler economy. When contracts primarily involved face-to-face transactions about animals, crops, or land, the relationships integrated almost spontaneously. The economic exchange was easily understandable, and likely informed by physical examination of the animal or land being traded or by the community reputation of a person whose services were being hired. The personal relationship may have been ongoing—the parties may have already known one another, or been part of families that interacted in various ways. Finally, the legal relationship was not complex. The consideration was paid, and the ownership transferred; or the service was performed in a workmanlike fashion, and the fee then became due. The three relationships comprising contracts overlapped significantly, and almost

naturally, as in Figure 1 below.

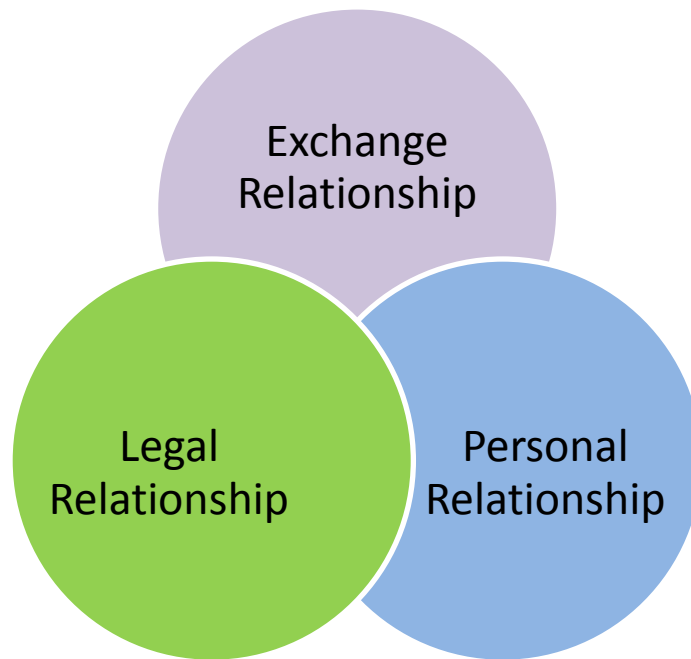


Figure 1: Contracting as Overlapping, Integrated Relationships

As the economy gradually modernized, however, exchange became more complex, less personal, and more dominated by legal professionals and their language. The result was that the three relationships of contracting began to drift apart.

Further, a second trend appeared: the legal circle became proportionately larger than the other two circles. Contracts took on greater formality, and the surrounding legal concepts elaborated. The result is that contracts became longer, and with denser, legal language; and when that happened the document became less accessible to the parties who were engaged in the economic exchange. The personal relationship may also have become harder to maintain, as one of the effects of a strictly legal relationship is that the parties are assumed to operate “at arm’s length.”

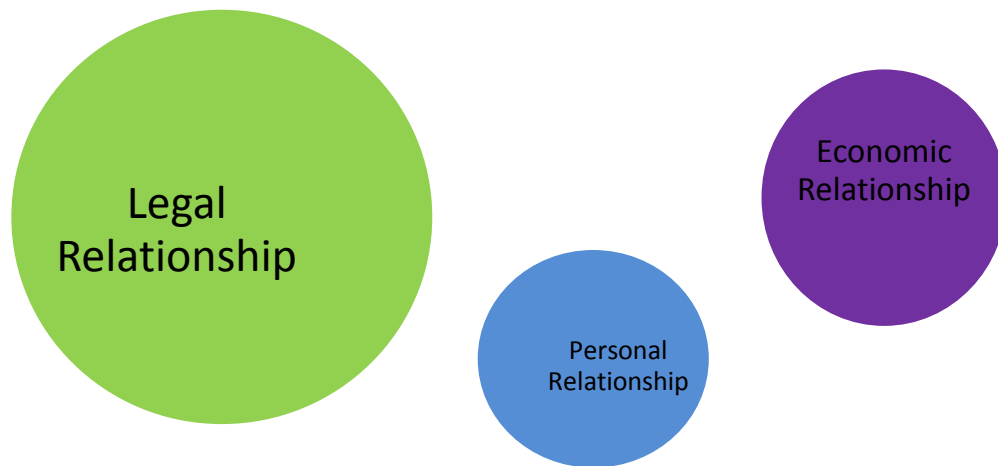


Figure 2: Contracting as Disconnected,  
Legally Dominated Relationships

When the three relationships of contracting are well-balanced and the overlaps are significant, communication and trust are easier to establish. Where the relationships are disconnected, and especially where the legal circle looms large over the others, communication becomes more difficult. Contract law may be characterized as creating a “smart” system in which users (i.e., business people or others needing to create or implement contracts) have a marginal role on the outskirts of an elaborate system that is operated by experts (i.e. lawyers and judges) and comprised of complex internal workings that are inaccessible by the users.<sup>12</sup> Users become dependent on experts to translate the users’ needs into a narrow sort of input for which the system is designed. The effect of such a system is to neglect or even de-value non-legal concepts or communications.

The communications structure of contract law, in other words, privileges legal ideas and vocabulary. That helps to explain why contracts become almost unreadable to those who are not legally trained and therefore tend to be neglected by the business user. More ominously the exclusive, specialist qualities of legal discourse tend to discourage general non-legal communications about matters that are specified in the contract. Indeed, contracts frequently contain a “merger” or “entire agreement” clause that formally disqualifies any significance for conversations that take place prior to the signing of the agreement, like the following:

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<sup>12</sup> Lessig, Lawrence (2001) *The Future of Ideas: The Fate of the Commons in a Connected World*. New York: Random House (pp. 26–34).

This instrument contains the only agreement of the parties relating to the subject matter and correctly sets forth the rights, duties, and obligations of each to the other in connection with it as of this date. Any prior agreements, promises, negotiations or representations not expressly set forth in this Agreement are of no force or effect.

“Collaboration” is therefore a conscious effort to introduce stronger communications into contracting. The formality of this effort and some of the structures that it recommends are reactions against the current influences that tend to discourage or narrowly channel conversations about contracting.

Bringing the three relationships of contracting closer together, and with better balance, is not easy for either lawyers or business managers. For lawyers, collaboration requires first that they de-emphasize legal rules to some extent, in favor of harnessing the power of economic and personal relationships. Healthy economic and personal relationships need not rely solely on legal rights. Where lawyers work toward making the economic and personal relationships stronger, therefore, the burden of dealing with risks does not fall exclusively on airtight legal language in the contract.

Lawyers should therefore embrace the value of non-legal communication. That in turn requires that the lawyers learn much more about the economic exchanges that are the subject of the contracts. They should treat their clients more like partners who are capable of contributing significantly to the success of the lawyer’s efforts. It also means that lawyers should make far greater effort to make their contracts readable by non-lawyers, a topic addressed further in the “Visualization” section below.

For managers, collaboration requires first that they not abdicate too much responsibility for formal contract processes to their lawyers. As suggested above, the relationship should be one of a partnership, and not one in which the manager looks after all “business” aspects of the contract while the lawyer is in charge of the “legal” aspects. Those categories are not pristine. More importantly, conceiving the categories as strongly distinct is one reason that the economic exchange and legal circles have drifted apart. Lawyers and managers should understand each other’s worlds as fully as possible.

Managers should also understand the worlds of their employees and any subcontractors.

## *Flexibility and Stability in Contracts*

Managers should flatten hierarchies that, for example, prevent production or sales personnel from making suggestions about the terms of prospective contracts or the implementation of existing contracts.

Finally, managers should invest time in talking with contractual counterparts about contract goals, risks, and implementation. In many cases managers should not be reluctant to share information about the economic or strategic interests that prompt willingness to enter into a contract. The underlying interests of a company do not give away negotiation strategies—it does not mean that a manager invites exploitation. Instead, managers should explain the broader interests of their company as a prelude to negotiating the contract.

Informing the other side about the basic goals for the exchange, rather than insisting solely on particular clauses, introduces a positive flexibility: by knowing the underlying interests the other side may be able to devise ways to satisfy those interests in novel, more efficient ways. If so, both parties have benefitted. Even without such breakthroughs, educating the other side of a negotiation about one's underlying interests will help maintain cordial personal relationships in the event that the negotiations break down. Both parties will better understand the basic constraints or intensity of certain needs, thus preventing anger and resentment if a deal cannot be struck.

A contract designed to prompt the positive flexibility of collaboration would consciously follow certain principles or values. Forrest S. Mosten, an expert advisor about collaboration in the context of divorce, lists some of those attributes:

- Respect and dignity for the other party and other professionals
- Direct and open communication with the other party and professionals
- Voluntary and full disclosure of relevant information and documents necessary to make agreements
- Use of interest-based negotiation to try to meet the needs of both parties.<sup>13</sup>

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<sup>13</sup> Mosten, Forrest S. (2009) *Collaborative Divorce Handbook: Helping Families Without Going to Court*. San Francisco: Jossey-Bass (p. 21).

What sorts of clauses might appear in a collaborative contract? In a preamble, collaborators might pledge any of the following:<sup>14</sup>

- to improve the quality of information they share, focusing from the beginning on their underlying interests and the risks they perceive;
- to work toward clauses that share risks in a balanced way, striving for maximal realization of *both* parties' interests;<sup>15</sup>
- to communicate in regularly scheduled meetings about the progress and quality of performances;
- when needed, to cooperate and perhaps even provide affirmative assistance toward another party's performance of its contractual duties;
- to work toward understanding and accommodating the needs of one another in response to changes, and to be open to modifying terms where conditions suggest the need for adjustment; and
- in the event of a dispute, to negotiate in good faith and to seek mediation and other alternative dispute resolution methods where initial efforts at negotiation fail.<sup>16</sup>

This list prompts at least three caveats.<sup>17</sup> First, consultation entails time and expense, and some items on the list may not be deemed efficient for some contracts.<sup>18</sup> That said, every contract builds a personal relationship, for better or worse. Sometimes what may appear to be unnecessary conversations, given the small dollar value of a particular contract, will be a worthwhile investment that leads to more significant future ties.

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<sup>14</sup> This list first appeared in Barton, Thomas D. (2012) "Collaborative Contracting as Proactive/Preventive Law", in Berger-Walliser, Gerlinde and Ostergaard, Kim (eds.) (2012) *Proactive Law in a Business Environment*. Copenhagen: Djof (p. 125–126)

<sup>15</sup> If one party consistently forces the other to accept unbalanced risks, the subordinated party may eventually be forced into breach—at which point both parties very likely lose value. Accepting a balanced sharing of the risks throughout the contract, even where opportunistic rent-seeking is possible, may well produce the best results over the life of a contract (or relationship). Crawford, Jacqui and Cummins, Tim (2010) *Collaborative Contracting: Is It Achievable?*, Webinar conducted under the auspices of the International Association of Contract and Commercial Management (IACCM), <https://www.iaccm.com/resources/?id=3446&cb=1408349619/> / [https://www.iaccm.com/resources/download.php?f=Ask\\_The\\_Expert\\_Recording-Jacqui\\_Crawford-April10.mp3](https://www.iaccm.com/resources/download.php?f=Ask_The_Expert_Recording-Jacqui_Crawford-April10.mp3)

<sup>16</sup> Macaulay, *supra* note 5, at pp. 784–788

<sup>17</sup> See Barton, *supra* note 14, at pp. 126–127.

<sup>18</sup> *Id.*



Second, some of the provisions suggested above may not be legally enforceable.<sup>19</sup> This does not necessarily undermine their value, however, toward prompting useful conversations. Although initial legal entitlements should be as clear as possible, using non-legal language to expand beyond legal certitude can be a step toward positive flexibility. Finally, could collaborative language give room for exploitative behavior?<sup>20</sup> Are such provisions naïve? Recall that most managers say they want relationships that are more trusting and personal.<sup>21</sup> We should take them at their word.

#### 4. Visualization

In contexts from cell phones to automobiles, from field guides to instruction manuals, “usability and user-experience are considered important dimensions of quality. Not so in contract drafting.”<sup>22</sup> As noted above, contracts evolved to carry a strong focus on “legal quality” and enforceability. Yet “[w]hile clients want their agreements to be enforceable, they also want contracts that enable them to achieve their business goals.”<sup>23</sup> Business decision makers have long complained about contracts being overly legalistic and difficult to work with. There is often a wide gap between deal-making and deal-drafting; managers drive the former, while lawyers drive the latter. Lawyers’ drafting easily alienates clients, including the executives and domain experts whose contributions would be crucial to the success of those contracts. But if clients disengage too much from the process, there is a danger that, echoing the title of a book chapter by Professor Deepak Malhotra, a *great deal* ends up with a *terrible contract*: “Great Deal, Terrible Contract”.<sup>24</sup>

As noted in the “Collaboration” section above, it is crucial that the people who participate in contracting communicate well with one another, at each stage of the contracting process. In

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<sup>19</sup> Id.

<sup>20</sup> Id.

<sup>21</sup> Macaulay, *supra* note 5, at pp. 790–795.

<sup>22</sup> Haapio, Helena (2013) “Designing Readable Contracts: Goodbye to Legal Writing—Welcome to Information Design and Visualization,” in *IRIS 2013 Proceeding, IRIS 2013* at p. 447.

<sup>23</sup> Id.

<sup>24</sup> Malhotra, Deepak. (2012) “Great Deal, Terrible Contract: The Case for Negotiator Involvement in the Contracting Phase” in Goldman, Barry M. & Shapiro, Debra. L. (eds.) (2012) *The Psychology of Negotiations in the 21st Century Workplace. New Challenges and New Solutions* New York: Routledge (pp. 363–398). For a more general discussion of the topic, see Haapio, *supra* note 22 and Haapio, Helena (2013) *Next Generation Contracts. A Paradigm Shift*. Helsinki: Lexpert.

complex contracts covering complex projects, for example in information and communication technology (ICT), equipment supply, or construction, a number of business managers and domain experts participate in writing and reading contracts in addition to legal professionals. At the writing stage, these often include technical experts who contribute to scope, specifications, requirements documents, testing and approval processes, as well as output and performance definitions. Beyond legal and technical terms, contracts often contain sophisticated financial terms and project-related timelines and procedures: hence finance and HR departments might also be involved. The backbone of a contract is hardly ever made from scratch but compiled using forms, templates, or clause libraries. While these are typically designed by lawyers, deal-specific information is required from other professionals, mostly business managers and engineers.<sup>25</sup> During negotiations, meetings are arranged and changes made to the contract, again activating lawyers, business managers, technical experts, and engineers on both sides. Once made and signed, contracts need to be implemented, and project managers and operational teams take over. The contents of the contract need to be translated into action. In order for businesses to reach their goals, contract-related communication must be effective.<sup>26</sup>

This chapter makes the point that visualization can promote both clarity and understanding among those who are affected by a contract and advance positive flexibility. What do we mean by visualization and how exactly can it be used in the context of contracting processes and documents? What can visualization do that traditional contract (or legal) writing cannot?

Visualization – adding icons, tables, charts and images to supplement text – is a core part of information design. Information design applies graphic design principles to information in order to communicate the information more effectively. It is the process of identifying, selecting, organizing, composing, and presenting information to an audience so that it can be used efficiently and effectively by that audience to achieve a specific purpose.<sup>27</sup>

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<sup>25</sup> Argyres, Nicholas and Mayer, Kyle J. (2007) “Contract Design as a Firm Capability: An Integration of Learning and Transaction Cost Perspectives”, 32 *Academy of Management Review*, at pp. 1060–1077.

<sup>26</sup> Passera, Stefania and Haapio, Helena (2013) “Transforming Contracts from Legal Rules to User-centered Communication Tools: a Human-Information Interaction Challenge.” *Communication Design Quarterly Review*, , Vol. I, Issue III, pp. 38–45, available at <http://sigdoc.acm.org/wp-content/uploads/2012/09/CDQ-April-1-3-FINAL.pdf>.

<sup>27</sup> Hayhoe, George F. (2012) “Telling the Future of Information Design”, 1 *Communication Design Quarterly Review* 23. [http://sigdoc.acm.org/wp-content/uploads/2012/09/CDQR\\_1-1\\_Fall2012.pdf](http://sigdoc.acm.org/wp-content/uploads/2012/09/CDQR_1-1_Fall2012.pdf).

The ultimate goal of information design and visualization is clear communication and enabling users to interact with the information. The selection of methods used is based on what is best suited to express the particular information at hand, to the particular user group, in a particular context. For easier reading, more prominence needs to be given to what is more relevant to the user.<sup>28</sup> Text alone can seldom provide prominence or salience to a piece of information. Visualizations can be used to do this, to make sure that the most important points are not lost.

Visualization puts the user—in our case the business people and the client—in the center. For clients, the core of contract design should be securing the performance the parties expect, not just a contract. It is not enough to know how to write well; one should also learn to engage others in the process, elicit information, and communicate the core message effectively to the different readers. If we take the goal of contracts as communication tools seriously, the contract drafter’s job changes from merely drafting a clear, enforceable contract (along with appendices) to *designing communication* with multiple user groups and varying information needs.<sup>29</sup>

In just one example of how complex information can be far more effectively communicated, consider Figure 3 below. It sets out graphically the gradual transfer of ownership—together with particular business and legal risks, rights, and duties—over a 15 year contractual relationship between a supplier and purchaser of equipment.<sup>30</sup> “The delivery process of complex industrial machinery is lengthy, and different responsibilities change hands from supplier to purchaser in different moments in time. A multiple timeline can help summarize this, providing a clear summary to the key persons involved. A higher level of awareness, in return, not only prevents misunderstandings, but also provides better insights for effective risk and change management.”<sup>31</sup>

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<sup>28</sup> Albers, Michael J. (2007) “Information Saliency and Interpreting Information” in *SIGDOC '07 Proceedings of the 25th annual ACM International Conference on Design of Communication*, 22–24 October, El Paso, Texas. New York: ACM, pp. 80–86.

<sup>29</sup> See Haapio, Helena (2013) *Next Generation Contracts. A Paradigm Shift*, *supra* note 22, pp. 63–68.

<sup>30</sup> This chart first appeared in Haapio, Helena, Passera, Stefania, and Barton, Thomas D. (2013) “Innovating Contract Practices: Merging Contract Design with Information Design”, in *Proceedings of the 2013 IACCM Academic Forum on Integrating Law and Contract Management: Proactive, Preventive and Strategic Approaches*, Ridgefield, CT: IACCM at p. 43.

<sup>31</sup> *Id.*

Transfer of ownership, risks, costs and responsibilities

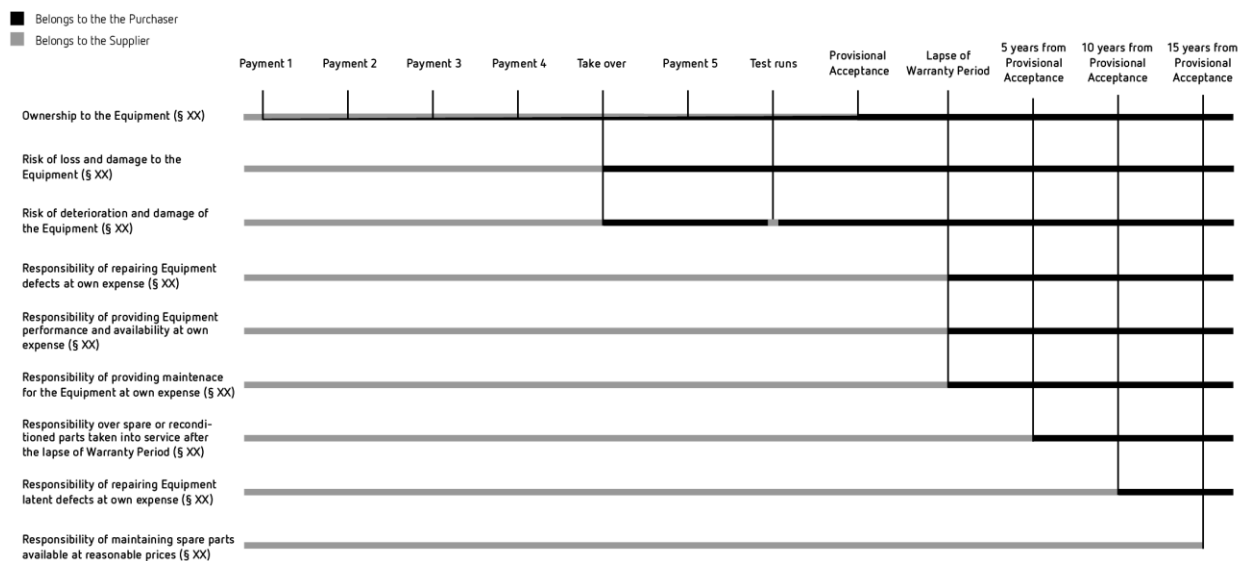


Figure 3. Multiple timelines showing the transfer of ownership and the allocation of risk, costs and responsibilities between parties (© 2012. Aalto University. Image by Stefania Passera. Used with permission.)

## 5. Conclusion

By analyzing and advocating the conscious introduction of flexibility into contracting, this article challenges some deeply-rooted assumptions about how we think and act in the law and business. Industrial-era production methods and institutions imagine stability and progress to be achieved by constructing machines that operate predictably and consistently. A world of perfect design is one that needs no tinkering or repair: a need is perceived; a method is imagined for satisfying that need; power is harnessed that is sufficient to sweep aside obstacles to that method; and the machine is set in motion to replicate standardized outcomes. Ideally, no further human input is required; tinkering evidences flaws in design or the breakdown in operation.

And so it is imagined to be with traditional contract processes and documents: Identify a need; imagine transactions to satisfy the need; create a contract that, aided by the power of the law, will replicate and secure those transactions with machine-like performance. No need to consult the contract after its expert creation: doing so is evidence of breakdown. To solicit broad participation and communication in the formation or implementation of a contract is to

insert amateurism, confusion, and uncertainty. That is the real world, says Chris.

But flexibility, in contracting as well as in decision-making, marketing, product design, planning, and probably every other aspect of business, is increasingly seen as a virtue rather than a weakness. Contracts backed by the power of the state were imagined to be capable of constructing an impervious future. But in a world of constantly accelerating change and crumbling borders, the law may no longer have the power to decree the future. Progressive businesses may not want that anyway. They understand that the future is neither pre-destined nor inexorable.<sup>32</sup> It is folly to believe we can fully predict it, and dangerous to attempt to fully construct it. Uncertainty is best managed through constant feedback and small adjustments.<sup>33</sup> That is best achieved from setting up processes that connect, not separate. Innovation comes from imagining and embracing alternative futures, not from suppressing them. Imagination is advanced by sharing ideas and interests, not by efforts toward secrecy or obfuscation. Visualization carries values about effective communication, which is the foundation of collaborative relationships, which in turn enable innovation, efficiency, and trust. As noted among Silicon Valley lawyers and their clients, the most technologically innovative industries demonstrate the most collaborative and flexible attitude to contracting. Kim seems to have the backing of recent history, and hopefully of the future.

Finally, though, it bears repeating that the perspective of Chris, relying on the law to provide stable expectations, is not only legitimate but in some ways vital. The legal theorist Niklas Luhmann understood law as a social process toward stabilizing normative expectations,<sup>34</sup> which in turn enables just those small adjustments that help cope with change. Clearly stated legal rights in a contract provide a helpful foundation of party expectations. Those expectations become more secure and more accurate when the parties talk forthrightly and cooperatively.

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<sup>32</sup> Popper, Karl (2013, first published in 1957) *The Poverty of Historicism*. London, NY: Routledge.

<sup>33</sup> *Id.*, at section 20–21 (at pp. 58–70).

<sup>34</sup> Luhmann, Niklas (1985) *A Sociological Theory of Law*, London: Routledge & Kegan Paul, at pp. 40–73; *see also* Barton, Thomas D. (1986) “Expectations, Institutions, and Meanings: A Review of Niklas Luhmann, *A Sociological Theory of Law*” 74 *California Law Review*, at p. 1805.

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Hayhoe, George F. (2012) “Telling the Future of Information Design”, 1 *Communication Design Quarterly Review* 23. [http://sigdoc.acm.org/wp-content/uploads/2012/09/CDQR\\_1-1\\_Fall2012.pdf](http://sigdoc.acm.org/wp-content/uploads/2012/09/CDQR_1-1_Fall2012.pdf).

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## Flexible Contracting in Software Project Business:

### What We Can Learn from Agile Methods in the Software Industry

JOUKO NUOTILA,<sup>1</sup> JAAKKO KUJALA,<sup>2</sup> SOILI NYSTÉN-HAARALA<sup>3</sup>

A contract between project parties defines agreements and actions for coordination, safeguarding, and adaptation during a project lifecycle.<sup>4</sup> Traditionally, literature has viewed contracts in a very legal oriented manner, where documents are designed by lawyers to protect different parties against risks and to get commitments from others; commitments that the law will enforce at the court in the worst case scenario.<sup>5</sup> This view is challenged by the agile approach in the software industry. Agile methods started to evolve in the early 1980s and the main principles were introduced in the Agile Manifesto in 2001.<sup>6</sup> After a decade these practices are commonly used in software development to increase flexibility and minimize negative impacts of changes in software projects. In project business, which is characterized by fierce competition, increasingly complex project networks, and unstable project environments, there is an increasing demand for proactive coordination and flexible adaptation for changes.<sup>7</sup> In this research, we investigated agile methods in the software industry and gained understanding on how the agile approach is used to maximize co-created value in the project and to increase flexibility in project contracting. Flexible contracting may work as an innovative tool for collaboration among project parties, potentially enabling dynamic project management and

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<sup>1</sup> Doctoral Student, University of Oulu, Finland.

<sup>2</sup> Professor of Project and Quality Management, University of Oulu, Finland.

<sup>3</sup> Professor of Commercial Law, University of Lapland, Rovaniemi, Finland, and Professor of Jurisprudence, Luleå University of Technology, Sweden.

<sup>4</sup> Argyres, N. & Mayer, K. J. (2007) "Contract design as a firm capability: An integration of learning and transaction cost perspectives." *Academy of Management Review*, Vol. 32, No. 4 (Oct 2007), pp. 1060-1077., Williamson, O.J. (1985) *The Economic Institutions of Capitalism*. Free Press, New York, NY. 450 p.

<sup>5</sup> Lumineau F. & Oxley J. E. (2012) "Let's work it out (or we'll see you in court): Litigation and private dispute resolution in vertical exchange relationships." *Organization Science*, Vol. 23, No. 3 (May/Jun 2012), pp. 820-834., Nystén-Haarala, S., Lee, N. and Lehto, J. (2010) "Flexibility in contract terms and contracting processes." *International Journal of Managing Projects in Business*, Vol. 3, No. 3, pp. 462-478., Siedel, G. J. & Haapio, H. (2010) "Using proactive law for competitive advantage." *American Business Law Journal*, Vol. 47, No. 4 (Winter 2010), pp. 641-686.

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contingency planning in various types of projects. This research presents our empirical findings from the software industry and facilitates discussion on how flexible contracting could be applied in project business beyond software development.

## 1. Introduction

The traditional view on contracts in project management research is that a contract defines agreements and actions for coordination, safeguarding, and adaptation during a project lifecycle.<sup>8</sup> In addition, legal scholars view contracts in a very legal oriented manner, where documents are designed by lawyers to protect different parties against risks and to get commitments from others; commitments that the law will enforce in court in the worst case scenario.<sup>9</sup> Because of these safeguarding oriented views on contracting, there is fundamental rigidity built into both project contracting processes and project contracts. Contracting parties must expend significant effort and resources to specifically define project artifacts and deliverables before signing the contract. There are also formal change management procedures involved in project management in order to adapt to required changes during the project implementation phase.

This type of formal, legal-centric contracting process and clunky, bureaucratic approach to project change management might work well with less complex projects, where the targeted result can be clearly and precisely defined, but many projects require a more flexible approach to be able to maximize co-creational value. For example, agile software development projects, where the aspired end-result cannot be precisely defined beforehand, tend to require increased flexibility to be able to maximise the created value. Our earlier research discovered that the demand for proactive coordination and flexible adaptation to changes by project parties is increasing, particularly in the context of project business characterized by complexity and uncertainty.<sup>10</sup> This is the case in agile software projects, which focus on cooperation with a customer, continuous re-defining of requirements, accepting the fact of constant changes in the project. Agile projects need flexibility to manage uncertainty, especially in the early phases of the project lifecycle when there is not enough

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<sup>8</sup> Argyres & Mayer (2007), Williamson (1985).

<sup>9</sup> Lumineau & Oxley (2012), Nystén-Haarala et al. (2010), Siedel & Haapio (2010).

<sup>10</sup> Kujala, J., Nystén-Haarala, S. and Nuottila, J. (2015) "Flexible Contracting in Project Business." *International Journal of Managing Projects in Business*, Vol. 8, No. 1, pp. 92-106.

information regarding the detailed specifications of the project scope and implementation of project work. In our earlier research we suggested that in software business there are two fundamentally different approaches to implementing flexibility in the contracting process and in the project contract: (a) postponing the decisions until there is adequate information for decision making; or (b) making decisions that allow flexible adaptation to changes during the project lifecycle.<sup>11</sup>

In this research we collected data from several industry professionals having extensive experience in agile software projects in order to study contracting practices and change management in those projects. We wanted to deepen our understanding on (RQ1) what are the salient characteristics of a project contracting process and project contracts when applying agile development methods. Furthermore, we wanted to empirically find out (RQ2) how agile software projects implement flexible approaches into project contracting and project contracts.

## 2. Agile Software Projects

The software development processes have evolved radically from traditional waterfall and spiral models which were suitable for traditional project management approaches, to today's agile and flexible development methods.<sup>12</sup>

The waterfall model was the first systematic and sequential approach to software development (Figure 1). It defined different project tasks in separate, isolated stages. It was a systematic approach to software development but at the same time it was rigid as it prevented

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<sup>11</sup> Kujala et al. (2015).

<sup>12</sup> Royce, W. W. (1970) "Managing development of large software systems" *Proceedings of IEEE Wescon*, Vol. 26, No 8 (Aug 1970), pp. 1-9., Boehm, B. W. (1976) "Software engineering," *IEEE Transactions on Computers*, Vol. C-25, No. 12 (Dec 1976), pp. 1226-1241., Boehm, B. W. (1986) "A spiral model of software development and enhancement." *ACM SIGSOFT Software Engineering Notes*, Vol. 11, No. 4 (Aug 1986), pp. 14-24., Boehm, B. W. (1988) "A spiral model of software development and enhancement." *Computer*, Vol. 21, No. 5 (May 1988), pp. 61-72., Pressman, R. S. (1997) *Software engineering: A practitioner's approach*. (Fourth ed.). New York: McGraw-Hill Companies Inc. 885 p., Warsta, J. (2001) *Contracting in software business: Analysis of evolving contract processes and relationships*. Doctoral Dissertation. Department of Information Processing Science and Infotech Oulu, University of Oulu. 262 p.

simultaneous activities and a previous stage was always to be completed first before a following one was possible to get started.

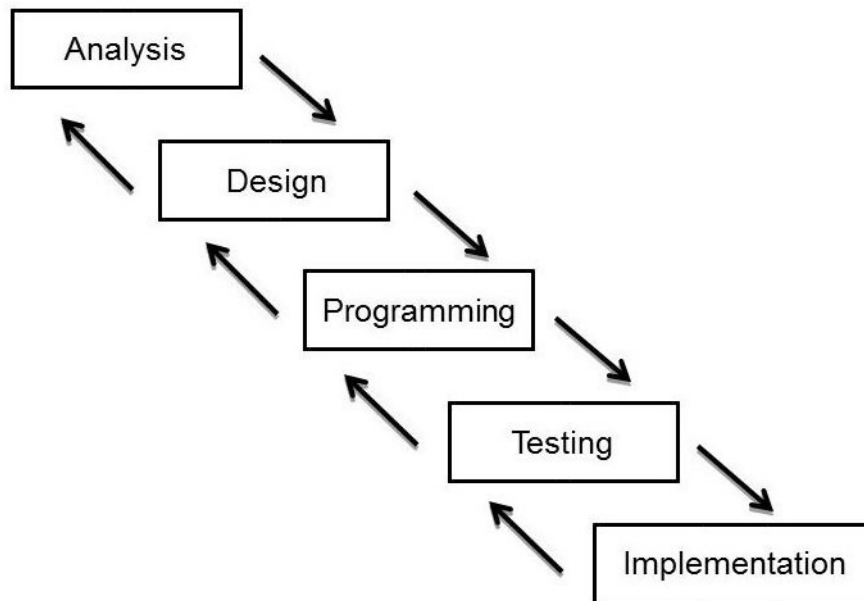


Figure 1. A waterfall model.

The waterfall model was often ineffective and inflexible. The product requirements were assumed to be known in the beginning of a project, there was a lot of documentation involved and the change management was bureaucratic and slow.<sup>13</sup> The model also had practical project management problems. For example, the product testing was done in the test phase as a whole. All the errors found in testing were then fixed after the test phase was over. Source code changes during the error fixing then possibly introduced new errors in software which were only found in the next round of testing and this could lead to a cycle of many loops between the code phase and the test phase thus increasing costs and delaying the project.<sup>14</sup> Because of these challenges with the waterfall model, a spiral model was developed.<sup>15</sup>

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<sup>13</sup> Curtis, B., Krasner, H., Shen, V. and Iscoe, N. (1987) "On building software process models under the lamppost." *Proceedings of the 9th international conference on software engineering*. IEEE Computer Society Press. pp. 96-103., Boehm (1988), Warsta (2001).

<sup>14</sup> Curtis et al. (1987), Liu, L.-C. & Horowitz, E. (1989) "A formal model for software project management." *IEEE Transactions on Software Engineering*, Vol. 15, No. 10 (Oct 1989), pp. 1280-1293.

<sup>15</sup> Boehm (1986), Boehm (1988), Warsta (2001).

The spiral model started to change software development into an iterative and more responsive direction. It divided a software project into smaller cycles, each cycle basically having all the phases introduced in the waterfall model. Initial assumptions and software architectural choices could be revisited after completing each cycle. The spiral model made software development more responsive to changes and it also involved customer more often enabling better interaction with the customer.

The evolution towards agile methods started in the early 1980s. As an example, one of the most popular agile methods, Scrum, was introduced in the late 1980s.<sup>16</sup> By 2001 several agile methods were used in the industry, and practitioners working with these methods agreed and signed the Manifesto for Agile Software Development.<sup>17</sup> It listed the main principles of agile methods in four value statements:

- individuals and interactions should prevail over processes and tools,
- working software prevails over comprehensive documentation,
- customer collaboration over contract negotiation, and
- responding to change over following a plan.

These statements demonstrated the fundamental change in the mindsets within software engineering. They introduced, facilitated and promoted more open, dynamic and flexible approaches for software project management and cooperation with customers.<sup>18</sup> The agile development model is presented in Figure 2.

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<sup>16</sup> Takeuchi, H. & Nonaka, I. (1986) "The new new product development game." *Harvard Business Review*, Vol. 64, No. 1 (Jan-Feb 1986), pp. 137-146.

<sup>17</sup> Rising, L. & Janoff, N. S. (2000) "The scrum software development process for small teams." *Software, IEEE*, Vol. 17, No. 4 (Jul-Aug 2000), pp. 26-32., Beck et. al (2001), Highsmith, J. & Cockburn, A. (2001) "Agile software development: The business of innovation." *Computer*, Vol. 34, No. 9 (Sep 2001), pp. 120-127.

<sup>18</sup> Cockburn, A. (2002) *Agile software development*. Addison-Wesley, Pearson Education, Inc. 278 p., Martin, R. C. (2003) *Agile software development: Principles, patterns, and practices*. Prentice Hall, Pearson Education, Inc. 529 p., Larman, C. (2004) *Agile & iterative development: A manager's guide*. Addison-Wesley, Pearson Education, Inc. 342 p., Tate, K. (2006) *Sustainable software development: An agile perspective*. Addison-Wesley, Pearson Education, Inc. 226 p.

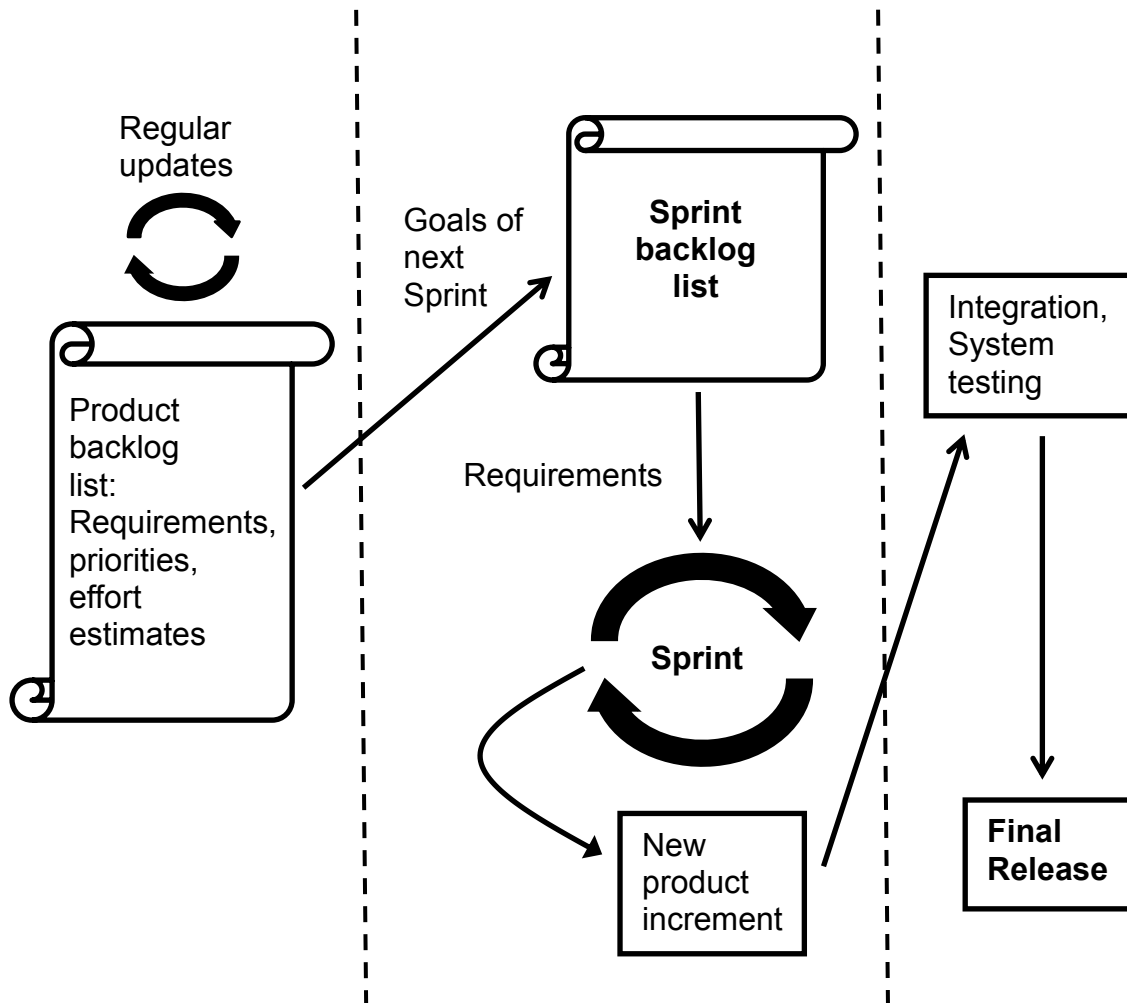


Figure 2. An agile development model.

A product backlog is a list of feature requirements which is regularly updated with the customer. It also contains information on priorities and work effort estimates of those requirements. A sprint is a period of implementation which usually lasts a couple of weeks. After each sprint, some product features are implemented completely and they can be integrated in the product increment. Finally, after several iterations of sprints, the final product release will be completed.

The agile development model, which emphasizes customer collaboration over contract negotiation, challenges not only the traditional project management but also the traditional contracting process which must evolve to increase the flexibility of contracting to match the

agile principles.<sup>19</sup> The ideas of flexibility have also emerged in contract law from the 1980's onwards. Contracts have been explained as developing gradually<sup>20</sup> and contracting parties have started to be required to act in good faith and take the other party's interests into consideration, at least to some extent (cf. Sund et al. in this volume). However, the change of paradigm has not been easy: research has documented many challenges in executing agile software projects successfully.<sup>21</sup> In addition to increased cooperation with customers, agile practices have been stated to encourage change rather than discourage it, by having focus on responding to change rather than on following a plan.<sup>22</sup> A valid question from the project business perspective is whether the understanding of the current contracting processes and project contracts is flexible enough to support the dynamic co-operation during the project execution.<sup>23</sup> Change mechanisms are seen as important contract terms, and yet they are most often absent from contract documents.<sup>24</sup> Empirical studies show a tendency to write hard and inflexible contract documents and bend the formal rules with oral changes.<sup>25</sup>

### 3. Contracting in Project Business

The nature of procurement within project business differs from the nature of industrial purchasing management—transactions which are more compatible with the traditional

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<sup>19</sup> Abrahamsson, P., Salo, O., Ronkainen, J. and Warsta, J. (2002) *Agile software development methods: Review and analysis*. VTT Publications 478, Otamedia, Espoo. 107 p., Beck et al. (2001), Nystén-Haarala, S. (1998) *The Long-Term Contract: Contract Law and Contracting*, Finnish Lawyers' Publishing, Helsinki. 325 p., Warsta (2001).

<sup>20</sup> Grönfors, K. (1993) *Avtalsgrundande rättsfakta* (Legal Facts Constituting Contracts), Nerenius & Santérus Förlag, Göteborg. 221 p., Pöyhönen, J. (1988) *Sopimusoikeuden järjestelmä ja sopimusten sovittelu* (The System of Contract Law and Adjustment of Contracts), Finnish Lawyers' Association, Helsinki. 397 p.

<sup>21</sup> Charette, R. N. (2005) "Why software fails?" *Spectrum, IEEE*, Vol. 42, No. 9 (Sep 2005), pp. 42-49., Cerpa, N. & Verner, J. M. (2009) "Why did your project fail?" *Communications of the ACM*, Vol. 52, No. 12 (Dec 2009), pp. 130-134.

<sup>22</sup> Beck et al. (2001), Higsmith & Cockburn (2001).

<sup>23</sup> Atkinson, S. (2010) "Why the traditional contract for software development is flawed?" *Computer and Telecommunications Law Review*, Vol. 16, No. 7, pp. 179-182.

<sup>24</sup> IACCM. (2012) *2012 Top terms in negotiation*. International Association of Commercial and Contract Management. Available at: <<http://www.iaccm.com/resources/?id=4611>> [Accessed 10 February 2015].

<sup>25</sup> Poppo, L. and Zenger, T. (2002) "Do formal contracts and relational governance function as substitutes or complements?" *Strategic Management Journal*, Vol. 23 No. 8, pp. 707-725., Corporate Contracting Capabilities Research Report. (2008) *Contracting capabilities in industrial life-cycle and service business*. 13 p. (CCC report 2008) Available at <<http://www.uef.fi/oikeustieteet/ccr>> [Accessed 9 February 2015].

contract law approach. It is important to understand the differences in the depth of the business relationships of these two procurement approaches. Industrial purchasing transactions can be considered as routine transactions compared to transactions and contracts in a more complex project business environment.<sup>26</sup> Breaches of contract, which contract law deals with, can similarly be more easily defined in connection with transactions. In project business it is crucial to have a climate of trust in a mutually motivating, cooperative relationship between the contracting parties. A trusting, collaborative relationship is required:

- to get all project participants to work towards project objectives<sup>27</sup> and to reach those objectives successfully;<sup>28</sup>
- to overcome possible misunderstandings and disagreements during the project and to be able to resolve disputes without litigation;<sup>29</sup> and
- to develop cooperative norms over the course of an extended exchange relationship,<sup>30</sup> to identify additional value creation and business opportunities during the project<sup>31</sup> and to identify and maintain future business prospects.<sup>32</sup>

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<sup>26</sup> Artto, K. A. & Wikström, K. (2005) "What is project business?" *International Journal of Project Management*, Vol. 23, No. 5 (July 2005), pp. 343-353.

<sup>27</sup> Turner (2004), Smyth et al. (2010), Ruuska, I., Ahola, T., Artto, K., Locatelli, G. and Mancini, M. (2011) "A new governance approach for multi-firm projects: lessons from Olkiluoto 3 and Flamanville 3 nuclear power plant projects." *International Journal of Project Management*, Vol. 29 No. 6, pp. 647-660.

<sup>28</sup> Turner (2004), Ruuska, I. (2005) *Social structures as communities for knowledge sharing in project-based environments*. [e-book] Doctoral Dissertation Series 2005/3. Laboratory of Work Psychology and Leadership, Helsinki University of Technology, Espoo. 234 p. Available at: <<http://lib.tkk.fi/Diss/2005/isbn9512276712/isbn9512276712.pdf>> [Accessed 9 February 2015]., Ruuska et al. (2011).

<sup>29</sup> Macaulay, S. (1963) "Non-contractual relations in business: A preliminary study." *American Sociological Review*, Vol. 28, No. 1 (Feb 1963), pp. 55-67., Lumineau & Oxley (2012), Smyth et al. (2010).

<sup>30</sup> Lumineau & Oxley (2012).

<sup>31</sup> Kujala, J., Murtoaro, J. and Artto, K. (2007) "A negotiation approach to project sales and implementation." *Project Management Journal*, Vol. 38, No. 4 (Dec 2007), pp. 33-44., Smyth et al. (2010), Kujala, J., Ahola, T. and Huikuri, S. (2013) "Use of services to support the business of a project-based firm." *International Journal of Project Management*, Vol. 31, No. 2 (Feb 2013), pp. 165-322.

<sup>32</sup> Skaates, M. A., Tikkanen, H. and Lindblom, J. (2002) "Relationships and project marketing success." *Journal of Business & Industrial Marketing*, Vol. 17, No. 5, pp. 389-404., Tikkanen, H., Kujala, J. and Artto, K. (2007) "The marketing strategy of a project-based firm: The four portfolios framework." *Industrial Marketing Management*, Vol. 36, No. 2 (Feb 2007), pp. 194-205., Smyth et al. (2010), Lumineau & Oxley (2012).

Some of these features of successful business relationship were already recognized in the 1960s by Macaulay,<sup>33</sup> who emphasized relational aspects of running business. Macaulay talked about deals that run in parallel or sometimes in contrary with the traditional written contracts. Deals<sup>34</sup> are commitments taken seriously in almost all situations by business people. Even if deals were not legally binding, they are often so respected that contract and contract law are almost unnecessary because of the many effective non-legal sanctions. Two norms are widely accepted by business people: (a) Commitments are to be honored, one does not waltz on a deal; and (b) one ought to produce a good product and stand behind it. These norms influence the behavior of contracting parties because both parties would like to operate successfully in the future and because they are concerned about their general business reputation in the market.<sup>35</sup>

While considering contracts from a project business perspective, which include contractual relations much more extensively than discrete transactions for the exchange of goods, it is important to note that business relations and agreements exist everywhere in various forms and shapes. According to Macneil<sup>36</sup> all contracts have relational elements, which, however, vary depending on the type and function of the contract. As Macneil<sup>37</sup> mentioned when he studied economic relations under classical, neoclassical and relational contract law: “*Were we to push far in the direction of contractual relations, we would come to the firm itself, since a firm is, in significant ways, nothing more than a very complex bundle of contractual relations*”.

Contrary to the need for trustful relations and flexibility in project business, mainstream legal studies have focused on anticipating all contingencies and including them in contracts. Contracts have been treated as complete agreements which should include all the potential solutions for contingencies that a reasonable person should have foreseen. Because of this, there is an emerging need to develop good, well-functioning and profitable contracts contributing to business cooperation instead of only safeguarding. Some legal scholars have started to move beyond the legal centralist approach and view contracts as not only

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<sup>33</sup> Macaulay (1963).

<sup>34</sup> as defined by Macaulay (1963).

<sup>35</sup> Macaulay (1963).

<sup>36</sup> Macneil, I. R. (1978) “Contracts: Adjustment of long-term economic relations under classical, neoclassical, and relational contract law.” *Northwestern University Law Review*, Vol. 72, No. 6 (Jan-Feb 1978), pp. 854-905.

<sup>37</sup> Macneil (1978).



documents written for potential disputes in court but more as a tool for business cooperation.<sup>38</sup> This proactive law movement attempts to find and develop multidisciplinary approaches for research on business contracting.<sup>39</sup> Typically, proactive law not only empirically studies how things are but also aims to contribute to better contracting in business.<sup>40</sup> Proactive law approaches contracts from a wider perspective, recognizing that contracts must be aligned with the subsequent business model and that the processes of the contracting parties have to be coordinated.<sup>41</sup> The contract document is seen as a tool for cooperation, where every person or team implementing it can find guidelines and instructions. The tool can also be adjusted to first account for contingencies and then to signal the changes to those who implement it. The proactive contracting approach is well aligned with the recent discussion in the project management literature about the role of contracts in supporting the business of a project-based firm.

### *3.1 Contracting Process and Contract Elements*

The project marketing literature describes the following steps in the project lifecycle: search, preparation, bidding, negotiation, implementation and transition.<sup>42</sup> In the beginning there is a business prospect on a seller side and a search for getting a problem solved on a buyer side. In the first contact of the project, contracting parties can see an option to create value together. First commitments are made during the first contact. The seller might commit to send more information about the products, references, and technical specifications. The buyer might commit to send more details on future plans and information on requirements of a project in question. Specification and marketing material related to the offer create expectations for the customer about the functionality of products and services provided by the supplier. From a business perspective, this can be considered as a commitment to include

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<sup>38</sup> Barton, T.D. (2009) *Preventive Law and Problem Solving: Lawyering for the Future*, Vandepals Publishing, Lake Mary, Fl. 382 p., Siedel and Haapio (2010).

<sup>39</sup> Nystén-Haarala, S. (2008) "Why does contract law not recognize life-cycle business? Mapping of challenges for future empirical research", in Nystén-Haarala, S. (Ed.), *Corporate Contracting Capabilities; Conference Proceedings and Other Writings*, Department of Law, University of Joensuu, Joensuu, pp. 18-32., Haapio, H. (2006) "Introduction to proactive law: a business lawyer's view", in Wahlgren, P. (Ed.), *A Proactive Approach*, (Vol. 49), Scandinavian Studies in Law, Stockholm Institute for Scandinavian Law, Stockholm, pp. 21-34.

<sup>40</sup> e.g. Haapio (2006), Siedel and Haapio (2010).

<sup>41</sup> Nystén-Haarala et al. (2010).

<sup>42</sup> Holstius, K. (1987) *Project export*. Research report 1, Lappeenranta University of Technology, Department of Industrial Engineering and Management. 67 p.

such functionality and features in the project. Psychologically, initial commitments are already made at this point. From a business perspective, it may be difficult to withdraw from the contracting process after psychological commitments have been created; this is especially true for the supplier.<sup>43</sup> When a more detailed discussion is started, companies enter into the bidding and a negotiation phase.<sup>44</sup>

As negotiations go further, psychologically binding commitments by individuals and organizations are getting stronger. In the bidding phase, the customer usually conducts tendering among several suppliers and receives formal offers from suppliers. The customer continues with a shortlist of suppliers and continues negotiating with them until the customer makes a decision and selects one supplier. However, customers often ask for binding proposals in the tender phase, which means that the customer can accept them without modifications, and these can be considered as binding contracts.<sup>45</sup> During the negotiations the business case and value creation models are getting clearer, legally binding agreements are completed, and finally a contract is signed. During the implementation phase, modifications to the project contract are made and agreed between the parties. In the transition phase, the project is accepted, the guarantee period starts and responsibility for the delivered system is transferred to the customer. Even in contract law, the legally binding effect of a contract can nowadays be seen as developing gradually during the negotiation process.<sup>46</sup> This idea contradicts with the earlier need to find a clear starting point for contractual liability, such as the signing of the final document. These new approaches in legal studies, however, tend to blur the decision-making of judges in courts.<sup>47</sup>

As discussed earlier, agile methods have changed the linear view of the contracting process in the software industry. For example, a requirement specification is not usually completed before the project starts and it is changed many times during the project. Also, agile methods promote “continual refinement of the product and project practices” and this means that project parties continuously seek for better project practices which might mean changes to the originally agreed conventions. Thus the agile approach means that the contracting process

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<sup>43</sup> Kujala et al. (2007).

<sup>44</sup> Kujala et al. (2007).

<sup>45</sup> Siedel and Haapio (2010).

<sup>46</sup> Pöyhönen (1988).

<sup>47</sup> Nysten-Haarala (1998), Scott, R.E. (2003) “A theory of self-enforcing indefinite agreements.” *Columbia Law Review*, Vol. 103 No. 7, pp. 1641-1699.

includes refinement and re-evaluation, and contracts can also be renegotiated during the implementation phase. This continuous and dynamic renegotiation in the contracting process is illustrated in Figure 3.<sup>48</sup> The default rules of contract law do not grasp the idea of continuous renegotiation. Although decision-making in courts can involve requirements for loyalty between contracting parties, changes are better made within the private autonomy of the contracting parties. Constant changes require trust between cooperative parties. Disputes are better solved and settled without courts or any law-driven tri-partial dispute settlement method.

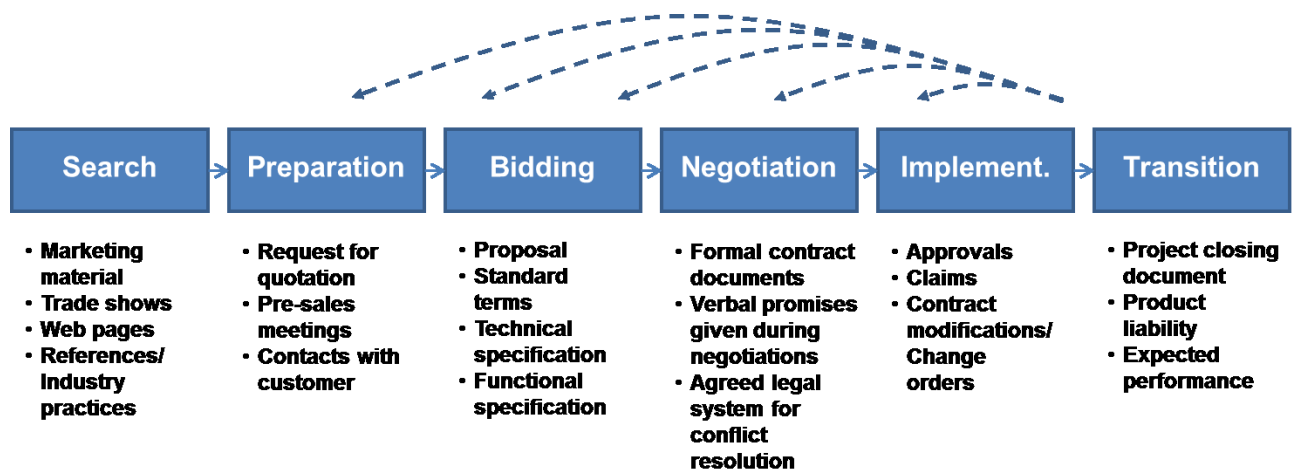


Figure 3. Contracting process in project business and the idea of renegotiation practices required by agile development methods.

#### 4. Methodology

Our empirical study is based on 5 semi-structured interviews with experienced professionals who have been involved in utilizing agile methods in software development for several years and who have been working with software development projects up to two decades. The informants are all from Finland, but their experience is from several companies in international software business and they are experienced in working with international software development projects. The information about the informants is presented in Table 1.

<sup>48</sup> Kujala et al. (2015).

Table 1. List of informants.

<b>Informant occupation</b>	<b>Experience (years)</b>	<b>Interview duration</b>	<b>No. of interviewers</b>
CEO of SW company	+ 20	105 minutes	2 researchers
Chief SW Architect	+ 15	95 minutes	1 researcher
Technical Lead of SW	+ 10	29 minutes	1 researcher
SW Sales Manager	+ 15	57 minutes	2 researchers
Managing Director of SW company	+ 10	104 minutes	2 researchers

The semi-structured interviews were used to gain insights into informants' experience on agile methods and their thoughts regarding impact of agile methods on flexibility in software projects. Four interviews were recorded and transcribed for analysis, one was transcribed during the interview and the transcription was reviewed with the informant immediately after the interview. The transcriptions were then taken into computer assisted qualitative data analysis software which was used to code the research data to identify emerging patterns of key concepts and issues and facilitate the data analysis.

## 5. Empirical Findings on Agile Software Projects

### *5.1. RQ1: Salient characteristics of a project contracting process and project contracts when applying agile development methods*

Based on the research data, a signed contract in agile software projects is usually a framework agreement or a framework contract between the project parties on project practicalities and governance, main responsibilities and price (per hour). It defines a mutually agreeable goal for the project and might include a high-level definition of the product to be created in the project. However, in many cases, the negotiations concerning the detailed scope of the product, project deliveries and services continue afterwards. Project parties work together on defining the requirements and features of the SW product and services and the contract can also be completed with supplements. This kind of contractual behaviour utilizing a frame agreement and supplements was demonstrated well in the interview with the CEO SW Company:

“In this case with our customer, it was a frame agreement which was signed. In the frame agreement we don't yet agree on what is going to be done, who is going to do it or when. In

the frame agreement we agree on confidentiality issues, possible recruiting issues, IPR issues, how payments are done and this kind of [issue]. Then we separately have an order for work specifically.”

“In the frame agreement it is also agreed how to proceed in a case of dispute. In this case it was agreed that arbitration will be held in Helsinki.”

“There were also some sanctions for us specified in the frame contract in case of our failure to meet the contract obligations.”

“In some frame contracts we have a clause which says that as a vendor we must guarantee the availability of agreed resources, this is quite normal in software project contracts.”

“In the contract there is always a list of responsibilities the customer must commit to. Participation in weekly meetings is listed there too.”

The agile methods promote continuous collaboration between the project parties and this requires frequent interaction to make decisions at the most optimal moment. Based on the research data, project parties continue to work together towards product specification after signing a framework contract. So they basically define the detailed scope of the project and product requirements after the project implementation phase is started. The agile methods enable project parties to continuously redefine project deliveries and services and to agree on required changes to maximize the value created in the project. This flexible approach to changes was clearly highlighted in the interviews:

“In agile (model), the changes and new requirements are mentally accepted; the organization has the culture of accepting changes and new requirements. This mindset makes the organization flexible and fast to react to changes.” – Chief SW Architect

“The agile methods have had a big impact in SW sales processes and SW development. Nowadays the intention is to get the development started as soon as possible. Earlier there was a target to create very detailed specifications before the project start[s] but now with agile methods it is important to get the real product development (programming) ongoing faster.” – SW Sales Manager

“The project was going very well and it was agile. There was a rough specification of application and we defined the details every week as it is done in agile development process. The customer understood that for this kind of a project the traditional waterfall model does not work. So, it was going very well...” – Technical Lead of SW

“In my opinion, the customer is the owner of the product. During the weekly meetings we learn more about the customer’s ideas and wishes for the product. Many times [the] customer is saying that we would like to have this kind of a feature done like this. But then when you ask more about an original problem this feature would solve, you realize that it can be implemented in an easier way with less development time. Usually when you discuss with the customer about it they are fine with a suggested development idea so it is very interactive discussion with the customer in those planning meetings...” – CEO of SW Company

Traditional project management literature suggests that there are several types of uncertainties and changes in project requirements or project environment which create the most severe source of risk in reaching the project goals.<sup>49</sup> Uncertainty may arise from multiple sources, such as the basis of estimates, design and logistics, objectives and priorities, and uncertainty about fundamental relationships between the project parties.<sup>50</sup> While approaches based on the traditional project planning can address a part of the uncertainty, traditional project management techniques cannot address every aspect of it.<sup>51</sup> In practice there are always issues that cannot be foreseen, or issues that remain unknown until there is enough information cumulatively collected during the project. This is especially the case with new software development, in which the related project is unique in a much wider sense than is typical in more traditional industries. The agile methods have recognized this fact and the agile approach agrees that there certainly are major important issues in software projects that are beneficial to solve later during the project. Hence, flexibility in the contracting process is also required to overcome the challenges caused by uncertainty in the project. Based on the

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<sup>49</sup> Ward, S. & Chapman, C. (2003) “Transforming project risk management into project uncertainty management.” *International Journal of Project Management*, Vol. 21, No. 2 (Feb 2003), pp. 97-105., Carson, S. J., Madhok, A. and Wu, T. (2006) “Uncertainty, opportunism, and governance: The effects of volatility and ambiguity on formal and relational contracting.” *Academy of Management Journal*, Vol. 49, No. 5 (Oct 2006), pp. 1058-1077.

<sup>50</sup> Ward and Chapman (2003).

<sup>51</sup> Barros, M.O., Werner, C.M.L. and Travassos, G.H. (2004) “Supporting risks in software project management.” *Journal of Systems and Software*, Vol. 70 Nos 1-2, pp. 21-35.

research data, it is obvious that agile development methods set evolving requirements for the project contracting process and project contracts:

- In agile software development projects, the project contract continues to evolve after signing the project contract (which usually seems to be a frame agreement or a frame contract). Traditionally signing the contract has been seen as an end of the negotiation phase and as a start of the implementation phase. In agile projects, however, the contract is complemented by contract supplements, and product scope and requirement related issues are continuously renegotiated in the meetings between the project participants after each pre-set period of implementation (called sprint).
- To be able to respond to demands for increased flexibility in agile software development projects, the project contracting process needs to reach actively over the negotiation phase and project signing to cover the project implementation phase with actions needed. Traditionally, a simplified project contracting process included two sets of actions: (a) prepare and commit before signing the contract; and (b) execute and exit after signing the contract.<sup>52</sup> In agile projects, negotiations continue during the implementation phase of the project and this requires continued attention and actions in the project contracting process.

Evolving requirements for the project contracting process and project contracts can be demonstrated by combining the agile development model (Figure 2) and the model of the project contracting process (Figure 3). Based on the research data, the illustration of the dynamics between the development model and the project contracting process is presented in Figure 4.

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<sup>52</sup> Corporate Contracting Capabilities Research Report (2008).

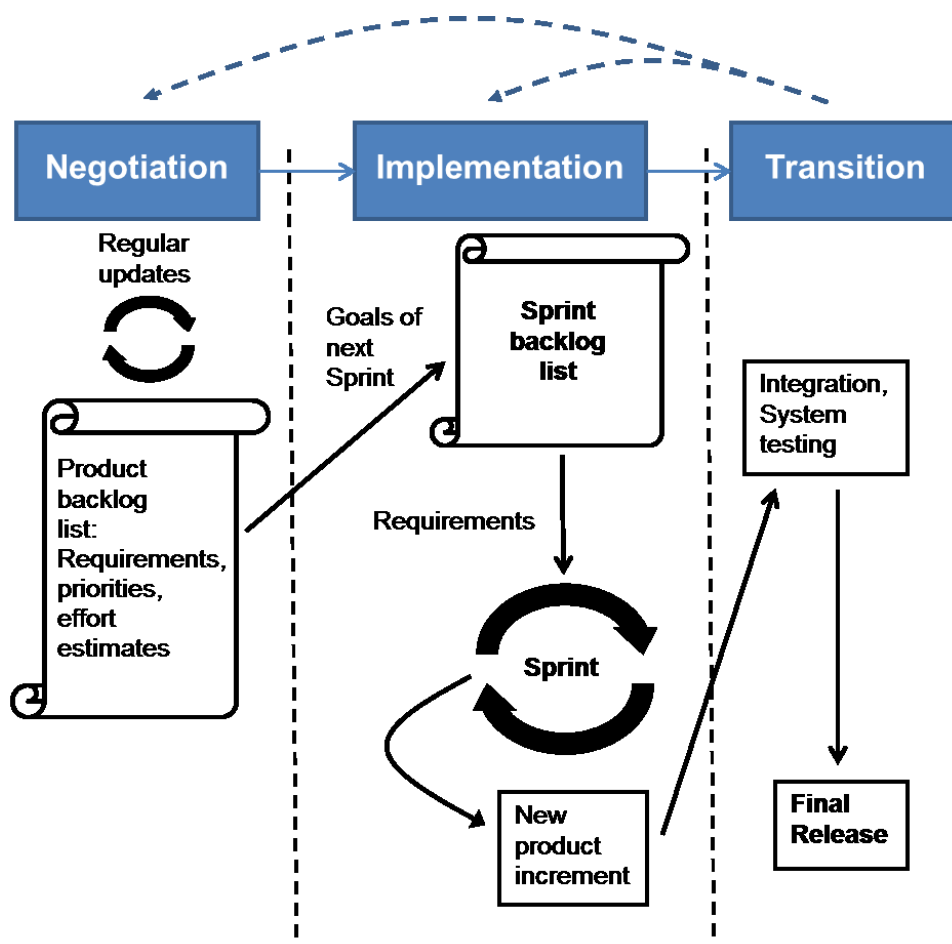


Figure 4. The dynamics between the agile development model and the project contracting process. The illustration recognizes the renegotiation practices and flexibility required by agile development methods.

The implementation phase starts based on the knowledge and mutual understanding developed during the negotiation phase. Implementation is done in sprints, which usually last a couple of weeks each. After each sprint, project parties review the result of previous sprint and agree on new requirements and changes to the existing ones. They also agree on the goals of the next sprint and on the detailed requirements to be implemented. After each sprint, the completed features and software components are released. In project management terms, they are delivered and the parties move into the transition phase. Figure 4 presents the iterative characteristics of agile methods and highlights flexibility and change adaptiveness included.

In addition to the previously presented impact on project contracts and contracting processes, agile methods also challenge contracting parties to truly collaborate. Only by continuously working together can they run a complicated project, maximize the co-creational value in the



project, and develop a high-quality software product. This challenge for a mental change was also demonstrated in the interviews:

“As a buyer, if you know your requirements exactly, then the agile model is not needed. This rarely is the case, so then the agile model is a good solution for purchasing SW. In the agile model it is important for the customer and the vendor to discuss continuously because then the customer can influence the priority order of requirements and understand the development cost of each requirement.” – Chief SW Architect

“Some organizations see agile methods only as a tool in the software development process and they can’t utilize [the] agile approach successfully. Agile methods are more like a mindset, the whole philosophy of value creation must change when you start to use agile methods. To be able to utilize the full potential of agile methods for increasing flexibility and enhance value creation, you need to understand the agile mindset. The customer is in the core of value creation; in the process of value creation, project parties create value together iteratively in minor pieces inside a major project. For some larger organizations this type of an ideology is strange, they just don’t understand it.” – Managing Director of SW Company

It is evident, based on our research, that utilizing agile methods to increase flexibility in project business requires changes also in project contracting and the project management approach. And this requires efforts and contribution from all project parties; both the buyer and the vendor must be able to commit to new project governance mechanism to support the agile approach. It is also important for business lawyers to understand that the agile approach virtually lengthens the negotiation phase of the project. Project parties voluntarily leave negotiable items open for later phases in order to avoid bad decisions and to maximize co-created value in the project.

## *5.2. RQ2: How agile software projects implement flexible approaches into project contracting and project contracts*

The hypothesis for the second research question based on our earlier research was that in software business there are two fundamentally different approaches to implementing flexibility in the contracting process and in the project contract: (a) postponing the decisions until there is adequate information for decision making or (b) making decisions that allow

flexible adaptation to changes during the project lifecycle.<sup>53</sup> We analysed the research data to see if there is evidence to support the hypothesis.

One of the stated values of the original agile manifesto is “responding to change over following a plan”. It identifies a challenge of complex projects involving unique technology solutions. It is impossible to know all the influencing details in the beginning of the project and it is also very difficult to specify all the requirements and specifications for the project start. Because of this, agile methods take changes as natural and inevitable incidents and project parties prepare for this mentally and by promoting fluent change mechanisms. This approach was demonstrated in the interviews too:

“[The] waterfall model is based on an idea that you can define all the requirements at once and based on those requirements you can design the whole SW architecture and the required work beforehand. In reality, it is extremely difficult to have such an understanding of a large and complex system at once. Also, customers do not know all the requirements beforehand; they do not have time and patience to do such a demanding planning work. Also they do not know all the requirements beforehand but they identify new and changed requirements during the SW planning when they see some plans and maybe prototypes.” – Chief SW Architect

“There were changes all the time in the project. As almost always is the case in the real projects like this. The original specification is always an initial one and you work to get it more detailed during the project and together with the customer you specify the application week by week until the customer is happy with it.” – Technical Lead of SW

We analysed the research data in more detail to identify concrete examples of how flexibility is implemented in agile projects. The findings are presented in table 2.

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<sup>53</sup> Kujala et al. (2015).

Table 2. Flexibility in agile development projects.

<b>Postpone decisions to reach adequate information</b>	<b>Allow flexible adaptation to changes</b>
a1. Detailed list of features for each software release decided during the project implementation phase	b1. The list of features for each software release can be changed based on a priority change, technical reasons etc.
a2. Customer can influence on project personnel during the project	b2. Customer is allowed to set new requirements and change the old ones in the meetings after each sprint
a3. Product specification in details is done incrementally during the project implementation phase	

In agile SW projects, project parties agree on a goal for the project and on a high-level definition of the product to be created in the project. They basically agree on a mutually acceptable direction of the project. But they leave the detailed list of features and technical choices open to be decided during the implementation phase of the project (a1). In this way, the features and order of their implementation can be decided when there is enough information on the priorities and related technology (a3). This approach reduces the detailed planning work allocated to the features which are dropped out of the product plans later. It also enables collaborative learning by project parties and enables better decision making at the later stages.<sup>54</sup> Based on our research on agile projects, the customer retains the possibility of influencing project resourcing (a2). The customer can make decisions or at least strongly influence the decision on the project personnel during the project. We consider also this to be one form of flexibility during the project.

One of the value statements of the agile manifesto was “responding to change over following a plan”.<sup>55</sup> Concrete implementation of this value was obvious in our research. Software is usually made available on several iterative releases. In an agile approach, the content of those releases can be flexibly changed, based on changes in priorities or in the technology environment (b1). The customer is also allowed to set new requirements during the whole project, and the change requests are considered to be a part of the normal routine of the implementation phase (b2). Based on the research data, the value principles of agile methods

<sup>54</sup> Pich, M.T., Loch, C.H. and De Meyer, A. (2002) “On uncertainty, ambiguity, and complexity in project management”, *Management Science*, Vol. 48 No. 8, pp. 1008-1023., Nightingale, P. and Brady, T. (2011) “Projects, paradigms and predictability”, in Cattani, G., Ferriani, S., Frederiksen, L. and Täube, F. (Eds), *Project-Based Organizing and Strategic Management* (Advances in Strategic Management, Volume 28), Emerald Group Publishing Limited, Bingley, pp. 83-112.

<sup>55</sup> Beck et. al (2001).

are used in practice in SW projects. They are used to get projects started earlier, to make contract negotiations easier, to increase collaboration, to increase flexibility and to manage uncertainty. These findings support the idea that a project contract needs to provide a flexible governance structure that allows adaptations to the contract through mutual agreement and enables early identification of problem situations and dealing with such situations in a cooperative fashion.<sup>56</sup> In agile projects, continuous communication between project parties facilitates cooperation and efficient change management to maximize co-creational value.

## 6. Conclusion

The emergence of the agile development model has radically changed internal dynamics of software development projects. It has also challenged the traditional view of project management and project contracting. In this research we wanted to discover the salient characteristics of the project contracting process and project contracts when applying agile development methods. Furthermore, we wanted to understand how agile software projects implement flexible approaches into project contracting and project contracts. We found some interesting results to our research questions, and invite additional research and discussions on these topics. Although the empirical data used in the research was limited, we think that the research provides important findings to be used as a basis for further research.

Based on this research, project parties utilizing agile methods define the detailed scope of the project and product requirements after the project implementation phase is started. They continuously redefine project deliveries and services and agree on required changes to maximize the value created in the project. Similarly, the project contract continues to evolve during the implementation phase. The original signed contract is complemented by contract supplements, and continuously renegotiated in the meetings between the project participants. Traditionally, a simplified project contracting process is divided into two phases: prepare and commit before signing the contract; and execute and exit after signing the contract. In agile projects, negotiations continue during the implementation phase of the project and this requires continued attention and actions in the project contracting process. It is important for business lawyers to understand that an agile approach lengthens the negotiation phase of the

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<sup>56</sup> Turner (2004).

project. Project parties voluntarily leave negotiable items open for later phases in order to avoid bad decisions and to maximize co-created value in the project. This finding also opens an interesting research question on the role of a business lawyer in agile projects, especially in the implementation phase. Also, another interesting question is the roles of individuals participating in the suggested renegotiations during the implementation phase of agile projects, and the formal or informal authority of these roles in negotiations, decision making and in the contracting process.

Many software projects produce a unique and novel solution. Thus, it is impossible to know all the influencing details in the beginning of the project and it is difficult to specify all the requirements at the beginning of a project. To cope with this fact, agile projects take changes as natural and inevitable, and project parties prepare for this mentally by promoting fluent change mechanisms. They leave the detailed list of features and technical choices open to be decided during the implementation phase of the project. The features and order of their implementation is decided when there is enough information on the priorities and related technology. The customer is also allowed to set new requirements during the whole project, and the change requests are considered to be a part of the normal routine of the implementation phase. This flexibility created by an agile approach, as well as the continuous communication between project parties, facilitates cooperation and efficient change management to maximize co-creational value. However, this kind of flexible contracting demands trust and cooperative norms between project parties. Thus, trust, communication and cultural issues between the project parties should be further researched in the context of flexible contracting and the agile project. Flexible contracting and agile project management is a fruitful area for multidisciplinary research, especially because the industries in project businesses seem to be evolving in that direction.

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# Flexibility in Contracts and Contractual Practice: Empirical Study in China

YANAN ZHANG,<sup>1</sup> RIITTA AHTONEN<sup>2</sup>

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 managers 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)

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<sup>1</sup> Lecturer and researcher, International Law School, Shanghai University of Political Science and Law, Shanghai, P.R. China, [yanan2@hotmail.com](mailto:yanan2@hotmail.com) or [yananzhang6@163.com](mailto:yananzhang6@163.com)

<sup>2</sup> University Lecturer, University of Eastern Finland, Joensuu, Finland, [riitta.ahtonen@uef.fi](mailto: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”.<sup>3</sup> 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.<sup>4</sup>

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.<sup>5</sup> 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.<sup>6</sup>

It has long been observed that *Guanxi* (relations or connections), are important factors when doing business with Chinese partners.<sup>7</sup> 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

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<sup>3</sup> 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.

<sup>4</sup> Zhai, Yuanjin (2009) “Chinese Contract Law and the Economic Reform”, *Transition Studies Review*, Vol. 16 (pp. 429–437).

<sup>5</sup> Peerenboom, Randall (2002) *China’s Long March Toward Rule of Law*. Cambridge University Press, (pp. 280-282 and 295-298).

<sup>6</sup> 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).

<sup>7</sup> 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.<sup>8</sup> 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.<sup>9</sup>

However, the use of contract is still prevalent in China, although the Chinese legal system is relatively weak.<sup>10</sup> 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.<sup>11</sup>

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.<sup>12</sup> Compared with discrete contracts, relational contracts are longer in term, are

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<sup>8</sup> 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).

<sup>9</sup> 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).

<sup>10</sup> Zhou, Xueguang; Zhao, Wei; Li, Qiang and Cai, He (2003) "Embedness and Contractual Relationships in China's Transitional Economy", *American Sociological Review*, 68, (pp. 75–102).

<sup>11</sup> 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.

<sup>12</sup> 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.<sup>13</sup> 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.<sup>14</sup> 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.<sup>15</sup> 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.<sup>16</sup> A co-operative attitude is indeed essential for dealing with contingencies in long-term contracts; otherwise,

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<sup>13</sup> Spiedel, Richard (2000) "The Characteristics and Challenges of Relational Contracts", *Northwestern University Law Review*, Vol. 94 (p. 823).

<sup>14</sup> Kreiner, K. (1995) "In Search of Relevance: Project Management in Drifting Environments", *Scandinavian Journal of Management*, Vol. 11, No. 4, (pp. 335–346).

<sup>15</sup> Olsson, Nils O.E. (2006) "Management of Flexibility in Projects", *International Journal of Project Management*, Vol. 24, Issue 1, Jan. (pp. 66–74).

<sup>16</sup> 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.<sup>17</sup>

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.<sup>18</sup> 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.<sup>19</sup> 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.<sup>20</sup> 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.<sup>21</sup> But empirical questions on the topic of flexibility

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<sup>17</sup> 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).

<sup>18</sup> Schmitz, Amy J. (2007) “Consideration of “Contracting Culture” in Enforcing Arbitration Provisions”, *St. Johns Law Review*, Vol. 81 (p. 123).

<sup>19</sup> 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).

<sup>20</sup> *Ibid.*

<sup>21</sup> 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.<sup>22</sup> 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.<sup>23</sup>

Relational contract theory appreciates the context of the exchange, and focuses on the necessity and desirability of trust, mutual responsibility and connection.<sup>24</sup> Therefore,

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Law and Economics Series, No. 12-02, available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1998483](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1998483), accessed 19 June 2013.

<sup>22</sup> Nystén-Haarala, Soili and Lee, Nari and Lehto, Jukka (2010), note 16 above.

<sup>23</sup> Matthews, R. C. O. (1986) “The Economics of Institutions and the Sources of Growth”. *Economic Journal*, Vol. 96 (pp. 903–918).

<sup>24</sup> 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.<sup>25</sup>

### *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.<sup>26</sup>

The costs of concluding a contract can be divided into ex ante and ex post transaction costs.<sup>27</sup> 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.<sup>28</sup> Another reason for incomplete contracts is bounded rationality. Because of the limits of

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<sup>25</sup> Wang, Yongqin and Li, Ming (2009) “Costs and Benefits of Relational Contracting in China’s Transition”, *Transition Study Review*, 16 (pp. 693–709).

<sup>26</sup> Coase, Ronald (1960) “The Problem of Social Cost” *Journal of Law and Economics*, Vol.3, (pp. 1–44).

<sup>27</sup> 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).

<sup>28</sup> Klein, Benjamin (2000) “The Role of Incomplete Contracts in Self-Enforcing Relationships”, *Revue d’économie industrielle*, 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.<sup>29</sup>

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.<sup>30</sup>

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.<sup>31</sup>

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.<sup>32</sup> 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.

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<sup>29</sup> Simon, Herbert (1955) "A Behavioral Model of Rational Choice", *Quarterly Journal of Economics*, Vol. 69, (pp. 99–118).

<sup>30</sup> Schwartz, Alan and Scott, Robert (2003) "Contract Theory and the Limits of Contract Law", *Yale Law Journal*, Vol. 113, (pp. 541–618).

<sup>31</sup> Klein, Benjamin (2000) "The Role of Incomplete Contracts in Self-Enforcing Relationships" *Revue d'économie industrielle*, Vol. 92, 2e, (p. 69).

<sup>32</sup> 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”.<sup>33</sup> 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.<sup>34</sup>

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.<sup>35</sup>

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

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<sup>33</sup> 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).

<sup>34</sup> Posner, Richard (2003), *Economic Analysis of Law*, 6<sup>th</sup> Edition, New York: Aspen Publishers (p.93).

<sup>35</sup> 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).

<sup>36</sup> North, Douglass C. (1992) “Institutions and Economic Theory”, *The American Economist*, Vol. 36 (1), (pp. 3–6).

<sup>37</sup> 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.<sup>38</sup>

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.<sup>39</sup>

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.<sup>40</sup>

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

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<sup>38</sup> 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).

<sup>39</sup> Klein, Peter G. (2000), *New Institutional Economics* in Boudewijn, B and De Geest, G. (eds.) *Encyclopedia of Law and Economics* University of Ghent: Edward Elgar (pp. 456-489).

<sup>40</sup> 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.<sup>41</sup>

Another informal enforcement mechanism is reputation. Because reputation signals trustworthiness, companies have an intrinsic desire to maintain their good reputation.<sup>42</sup> 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.<sup>43</sup>

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.<sup>44</sup>

### *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

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<sup>41</sup> 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'économie industrielle*, Vol. 92, 2e, (pp. 67–80).

<sup>42</sup> 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).

<sup>43</sup> Williamson, Oliver E. (1991) "Comparative Economic Organization: The analysis of discrete alternative", *Administrative Science Quarterly*, Vol. 36, (pp. 269–296).

<sup>44</sup> 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.<sup>45</sup>

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.<sup>46</sup> 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.<sup>47</sup>

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.<sup>48</sup>

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<sup>45</sup> 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", *Northwestern 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).

<sup>46</sup> Macaulay, Stewart (1963) "Non-contractual Relations in Business: A Preliminary Study" *American Sociological Review*, Vol. 28, (pp.55–67).

<sup>47</sup> Macneil, Ian (1980), *The New Social Contract: An Inquiry into Modern Contractual Relations*. New Haven, NJ: Yale University Press.

<sup>48</sup> 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](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.<sup>49</sup> 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.<sup>50</sup>

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<sup>49</sup> 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.

<sup>50</sup> Klein, Benjamin (2000) “The Role of Incomplete Contracts in Self-Enforcing Relationships” in *Revue d'économie industrielle*, 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.<sup>51</sup>

### 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

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<sup>51</sup> 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 phase of the project.

Most answers towards flexibility are positive. Flexibility is even considered a kind of subconsciousness 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, manager); 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.<sup>52</sup> 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.

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<sup>52</sup> 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*

Flexibility 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 measures are 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 view about the suitable amount of flexibility. A certain degree of flexibility is needed, but too much flexibility could make the contract lose its value 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.<sup>53</sup>

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

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<sup>53</sup> 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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Interviews:

C1, manager, Interview, conducted on 12 July 2012, Thursday, Beijing.

C2, corporate legal counsel, Interview, conducted on 18 July 2012, Wednesday, Shanghai.

C2, manager, Interview, conducted on 18 July 2012, Wednesday, Shanghai.

C3, manager, Answers to Interview Questions, delivered received on 20 July 2012, Friday, from Shanghai.

F1, Corporate legal counsel, Interview, conducted on 16 July 2012, Monday, Beijing.

F1, manager, Interview, conducted on 04 July 2012, Wednesday, Shanghai.

F2, manager, Interview, Conducted on 03 July 2012, Tuesday, Shanghai.

F3, Corporate legal counsel, Interview, conducted on 03 July 2013, Tuesday, Shanghai.

L1, Lawyer, Law Firm, Interview, conducted on 13 July 2012, Friday, Beijing.

L2, Lawyer, Law Firm, Interview, conducted on 16 July 2012, Monday, Beijing.

L3, Lawyer, Law Firm, Interview, conducted on 09 July 2012, Monday, Hangzhou.

L4, Lawyer, Law Firm, Answers to Interview Questions, received on 20 July 2012, Friday, Shanghai.

**Legal implications of flexibility in business contracting  
from the German perspective:  
Control of standard terms and conditions and the choice of law<sup>1</sup>**

RA DR. HANS-WERNER MORITZ<sup>2</sup> & RA MAXIMILIAN KUHN<sup>3</sup>

This paper is concerned with flexibility in business contracting within the German legal system. After a short introduction about the constitutional background of freedom in contracting in the Federal Republic of Germany it describes in the first part how freedom of business contracting is actually considerably curtailed within the German legal system.

The German Civil Code (BGB) provides for a rigid control of standard terms and conditions through the German courts: While there are detailed provisions regulating the dos and don'ts in commercial B2C contracts, the law allows the users of standard terms and conditions more flexibility in B2B contracts. However, German courts very often do not sufficiently distinguish between B2B and B2C contracts and apply the stringent B2C rules to B2B contracts without taking account of the requirements and established business practices in a given industry. The authors introduce several suggestions how to solve this issue.

The second part of the paper deals with the possibility of choice of law under the prerequisite not to completely leave the German legal system. Discussed are the regimes of CISG and PECL as alternatives to the current German regime.

## 1. Preamble

This survey describes legal implications of flexibility in business contracting from the German perspective. European aspects will be included in so far as they have a bearing on the German perspective.

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<sup>1</sup> Last update: August 2013.

<sup>2</sup> Moritz & Moritz, Rechtsanwälte in Bürogemeinschaft, D -82544 Egling, hw.moritz@web.de.

<sup>3</sup> Meister Rechtsanwälte Partnerschaftsgesellschaft, D-80331 München, m.kuhn@meisterlaw.de.

The flexibility issue addressed in this project directly relates to the freedom of individuals and corporations to form contracts without government restrictions. The freedom to contract is the underpinning of laissez-faire economics and is the cornerstone of free market libertarianism.

## 2. Definitions

In Germany freedom of contract is protected by Article 2 subsection 1 of the Constitution which provides that everyone may contract with which every party and for whatever subject matter one chooses, insofar as the content is not contrary to current law or public policy, or expressly statutorily forbidden.

Freedom of contract can be distinguished as follows:<sup>4</sup>

### *2.1. Freedom to enter into contracts*

Freedom to enter into contracts is the freedom of a person, to decide on his or her own terms whether, where, when and with whom he or she wishes to enter into a contractually binding relation with another person. This freedom may be limited by mandatory obligations to conclude a contract. An example of such obligation is the supply of electricity, where the electricity provider must supply the customer.

### *2.2. Freedom of the contractual form*

Freedom of the contractual form means that one does not have to use a set form for the contract or choose a form defined by statute. There are some exceptions, e.g. for contracts

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<sup>4</sup> The following definitions are suggested by Notariat Michael Becker, Königstraße 17, D-01097 Dresden, available at <http://www.koenigstrasse17.de/lang-de/notars/278-vertragsfreiheit.html>.

including estate transfer, which are only valid by notarization according to section 311b subsection 1 German civil code (BGB)<sup>5</sup>.

### *2.3. Freedom of content*

Freedom of content means that one can determine the content of the contract as one wishes, including allowing for the creation of new types of contract.

The following survey will address all aspects of the above definitions.

## 3. General rules of contract law in Germany

The BGB generally provides for freedom of the content of a contract (section 311 BGB). However, a contract is null and void if its content is contrary to mandatory law (section 134 BGB) or contrary to good faith and fair dealing (section 138 BGB).

### *3.1. Standard terms and conditions in the BGB*

Furthermore standard terms and conditions used by a contract party are null and void if they inadequately disadvantage the other contract party contrary to the requirements of good faith and fair dealing (section 307 BGB). Section 307 BGB also applies to B2B-contracts however courts must adequately consider commercial usages and commercial practices.

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<sup>5</sup> German Civil Code (Bürgerliches Gesetzbuch, BGB) in the version promulgated on January 2, 2002 (Federal Law Gazette (Bundesgesetzblatt) I p. 42, 2909; 2003 I, p. 738), last amended by statute of September 28, 2009 I 3161, online available at <http://www.gesetze-im-internet.de/bgb/BJNR001950896.html> and translated into English at [http://www.gesetze-im-internet.de/englisch\\_bgb/englisch\\_bgb.html](http://www.gesetze-im-internet.de/englisch_bgb/englisch_bgb.html).

### 3.2. Control of standard terms and conditions by the courts

#### 3.2.1. *De lege lata*

Actually industry associations and legal experts are vividly discussing in Germany whether the control of standard terms and conditions in B2B-contracts is too rigid and should be reformed. De facto the jurisdiction does in the majority of cases not distinguish between consumer contracts and those without consumers as one of the contracting parties, although such distinction is expressly made in the BGB (Vogenauer, 2013, pp. 264 et seq.). Basically three proposals are under discussion.

#### 3.2.2. *De lege ferenda*

3.2.2.1. Discussed is the relaxation of the strict requirements, which are currently demanded by the jurisdiction for the existence of an uncontrolled individual agreement. According to section 305 subsection 1 sentence 3 BGB, clauses have to be checked as standard terms and conditions when they are supposed to be used more than only once by one of the contracting parties and have not been topic in negotiations in a certain way. Actually, the German Federal Supreme Court accepts only as an “Aushandeln im Einzelnen” (lit.: negotiation with full details) in the sense of section 305 subsection 1 sentence 3 BGB, if the content of the standard terms and conditions, which is deviating from law, is seriously put to the decision by the using party, and the negotiating partner is given freedom of scope to represent his interests; according to that, the client has to get in real terms the possibility to influence the content of the contractual obligations.<sup>6</sup>

Reformers argue against this judicative principle, which says that “Aushandeln” means more than simply “Verhandeln” (lit. also negotiate). According to them, it should be easier to exclude single clauses from the control according to section 305 et seq. BGB by making them a topic in contract negotiations.<sup>7</sup> Some even don’t want to wait for a change in jurisdiction,

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<sup>6</sup> BGH (Bundesgerichtshof - German Federal Supreme Court) in: Neue Juristische Wochenschrift - NJW (1998) p. 3488, on p. 3489; BGHZ (civil law decisions by the German Federal Supreme Court) 150, p. 299, on p. 302 et seq. = Neue Juristische Wochenschrift - NJW (2002) p. 2388, on p. 2389.

<sup>7</sup> Fornasier, „Die Klauselkontrolle im unternehmerischen Geschäftsverkehr - für eine Neubestimmung der zivil- und kartellrechtlichen Grenzen der Vertragsfreiheit“, published in: Forschungsinstitut für



which would be possible under current law but would probably take its time due to the German legal system, but call for a revision of section 305 BGB by the legislator.<sup>8</sup>

3.2.2.2. Others propose that judicial control of standard terms and conditions should only happen depending on the value of the deal. A judicial control of the standard terms and conditions should not happen, if the value of the contract is above a certain limit, usually determined at a scale between 500.000,- € and 1 Mio. €.<sup>9</sup> This approach is based on a new theory, according to which the true reason for the protection against standard terms and conditions by law is not the need for compensation because of the difference in economic power between the contracting parties, but to override information- and motivation asymmetries between them, because for the contracting party being confronted with the standard terms and conditions it's often not worth the trouble to read all the fine print as regularly only a single contract of often small value is at stake.<sup>10</sup>

The Problem with this is how to set the value of a contract. Furthermore it makes a difference, if a contract is part of the core business or not or if it's only about a single contract between the contracting parties or several contracts within running business relations.

3.2.2.3. There's also a discussion about changing the case law regarding section 307 BGB, using the words „unangemessene Benachteiligung“ (lit.: inadequate disadvantage) for more leeway in B2B-cases. Particularly, it is suggested that courts no longer use the interdictions of certain clauses for B2C-contracts in section 308 BGB and section 309 BGB as an indication for qualifying a clause as an „unangemessenen Benachteiligung“ in the sense of the blanket clause in section 307 subsection 1 sentence 1 BGB.

As mentioned above under a), because of the peculiarities of the German legal system such a change will take time, because rulings of the German Federal Supreme Court will be needed.

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Wirtschaftsverfassung und Wettbewerb e.V., Köln (FIW), *Schwerpunkte des Kartellrechts 2011*, Carl Heymanns Verlag, Cologne Munich (2012), p. 16, on p. 21 et seq.

<sup>8</sup> Berger, „Für eine Reform des AGB-Rechts im Unternehmerverkehr“, published in *Neue Juristische Wochenschrift - NJW* (2010) p. 465, on p. 467.

<sup>9</sup> Leuschner, „AGB-Kontrolle im unternehmerischen Verkehr - Zu den Grundlagen einer Reformdebatte“, published in: *Juristenzeitung - JZ* (2010), p. 875, on p. 883 et seq.; Fornasier, please see fn. 4, on p. 22.

<sup>10</sup> Fornasier, please see fn. 4, on p. 19 et seq.

And therefore cases are necessary which find their way to the German Federal Supreme Court, which is even more difficult as by now there exists abundant case law (“ständige Rechtsprechung”) of the lower courts concerning section 305 et seq. BGB, and therefore, there is - according to section 543 subsection 2 German civil procedure code (ZPO)<sup>11</sup> - hardly a reason for lower courts to allow appeal to the German Federal Supreme Court.<sup>12</sup>

#### 4. Control of standard terms and conditions through the act against restrictions of competition

Although the control of standard terms and conditions in the BGB aims to protect the individual contractual counterpart and the German Act against Restrictions of Competition (GWB)<sup>13</sup> aims to protect competition in principle, both laws can generally be applied side by side, especially due to their different aims and intervention limits.<sup>14</sup> From the perspective of the above mentioned new theory, that control of standard terms and conditions as laid down in the BGB in section 305 et seq. BGB is not intended to compensate differences in economic power between the contractual parties but to override asymmetries in information and motivation between them (cp. above), a protection gap is opened, that possibly could be closed by certain reforms of the GWB.<sup>15</sup>

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<sup>11</sup> German civil procedure code (Zivilprozessordnung, ZPO) in the version promulgated on 5 December 2005 (Federal Law Gazette (Bundesgesetzblatt) I p. 3202 ;2006 I p. 431) (2007 I p. 1781) last amended by statute of 22 December 2011 I 3044, online available at <http://www.gesetze-im-internet.de/zpo/BJNR005330950.html>.

<sup>12</sup> Berger, „Für eine Reform des AGB-Rechts im Unternehmerverkehr“, published in *Neue Juristische Wochenschrift - NJW* (2010) p. 465, on p. 466; Fornasier, please see fn. 4, on p. 2 et seq.

<sup>13</sup> German Act against Restrictions of Competition (Gesetz gegen Wettbewerbsbeschränkungen, GWB) in the version promulgated on 15 July 2005 (Federal Law Gazette (Bundesgesetzblatt) I p. 2114; 2009 I p. 3850), last amended by statute of 22 December 2011 I 3044, online available at <http://www.gesetze-im-internet.de/gwb/BJNR252110998.html> and translated to English at [http://www.cgerli.org/index.php?id=50&tx\\_vmdocument\\_search\\_pi2\[docID\]=72](http://www.cgerli.org/index.php?id=50&tx_vmdocument_search_pi2[docID]=72).

<sup>14</sup> Ulmer/Brandner/Hensen, *AGB-Recht*, 11th edition (2011), Verlag Dr. Otto Schmidt KG, Cologne, Vorb. v. § 307 BGB, marginal numbers 76, 86.

<sup>15</sup> Fornasier, please see fn. 4, on p. 28.

*4.1. No practical significance de lege lata (Section 19 Subsection 4 no. 2 GWB)*

The GWB already today forbids market dominating enterprises to demand terms and conditions that deviate with high probability from those that would be established by effective competition (Section 19 Subsection 4 no. 2 GWB). In practice, the impact of this provision is quite small up to now. Reasons for this are first the high intervention limit of section 19 GWB, as only behavior of market dominating enterprises can be sanctioned, and secondly that the standard of scrutiny is difficult to handle: To declare the use of a term or condition as an abuse, a comparison with the situation under effective competition is required. This is quite complicated, especially as the German Federal Supreme Court asks for an overall view of the complete bundle of services (“Gesamtbetrachtung des Leistungsbündels”).<sup>16</sup> So it is not only to answer the question, if certain singular clauses would also be used in a market with effective competition, but also what their effect in the whole contractual exchange relationship (“Äquivalenzverhältnis”) is and if this is comparable to one concluded in a (hypothetical) market with effective competition.<sup>17</sup>

*4.2. Potential practical significance de lege ferenda*

A big advantage of the control of standard terms and conditions by the GWB in comparison to the control by section 305 et seq. BGB is, that a single clause must not be checked in isolation but also its interaction with other clauses and the whole contractual exchange relationship has to be taken into account.<sup>18</sup> The main problem with the GBW-approach is the limitation of section 19 GWB to market dominating companies. This limitation could be lowered according to the example of section 20 subsection 2 GWB by including also companies with a relatively strong position in the market, compared to depending small and medium-sized enterprises. Also the standard of scrutiny could be simplified, e.g. by also applying common legal measures of justice as stated in section 242 BGB (“good faith”) or

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<sup>16</sup> BGH (Bundesgerichtshof - German Federal Supreme Court), decision from 6.11.1984, Ref. No. KVR 13/83, in: Neue Juristische Wochenschrift - NJW (1986) p. 846, on p. 846.

<sup>17</sup> Fornasier, please see fn. 4, on p. 26.

<sup>18</sup> Fornasier, please see fn. 4, on p. 27.

section 138 subsection 1 BGB (“fair dealing”) as the standard of comparison.<sup>19</sup> However, currently no efforts of the legislator are known to move in this direction.

## 5. The possibility of choice of law

### *5.1. Eligibility of the law of contract*

There are two further law regimes under which a contract could be concluded (without leaving the German legal system at all): the United Nations Convention on Contracts for the International Sale of Goods (CISG)<sup>20</sup> and the Principles of European Contract Law (PECL)<sup>21</sup>. The CISG is part of the German legal system since 1. January 1991 and meshes particularly well with German law as it is strongly influenced by continental European legal principles.<sup>22</sup> The PECL are merely a set of model rules or restatement of principles of contract law, initiated by the European Commission and drawn up by leading contract law academics in Europe. However, the practical effects of CISG and PECL will probably be low:

### *5.2. Freedom of contract under the provisions of the CISG (Article 6) and under the counterpart provisions in the PECL*

Both, the CISG and the PECL, address the principle of freedom of contract (Article 6 CISG and Article 1:102, 1:103 PECL).<sup>23</sup> But while the CISG is applicable by law whenever the requirements of Article 1 subsection 1 lit. a) or lit. b) CISG and none of the exceptions in Article 2 - 5 CISG are fulfilled and the CISG is not excluded by the contracting parties (so

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<sup>19</sup> Fornasier, please see fn. 4, on p. 29.

<sup>20</sup> Full text online available at: <http://cisgw3.law.pace.edu/cisg/text/treaty.html>.

<sup>21</sup> Online available at:

[http://frontpage.cbs.dk/law/commission\\_on\\_european\\_contract\\_law/PECL%20engelsk/engelsk\\_partI\\_og\\_II.htm](http://frontpage.cbs.dk/law/commission_on_european_contract_law/PECL%20engelsk/engelsk_partI_og_II.htm).

<sup>22</sup> „Law - Made in Germany“, published by Bundesnotarkammer (BNotK), Bundesrechtsanwaltskammer (BRAK), Deutscher Anwaltsverein (DAV), Deutscher Industrie- und Handelskammertag e.V. (DIHK), Deutscher Notarverein (DNotV) and Deutscher Richterbund (DRB) in cooperation, 2nd edition (2012), p. 9; also online available at <http://www.lawmadeingermany.de/index.htm>.

<sup>23</sup> Schroeter, “Freedom of Contract: Comparison between provisions of the CISG (Article 6) and counterpart provisions of the PECL” in: *The Vidobona Journal of International Commercial Law and Arbitration*, Vol. 6 (2002), p. 257, on p. 259.

called “opt-out”, Article 6 CISG, only for the law of contracting states of the Convention), the PECL is only applicable when the parties have chosen it and otherwise applicable national law allows for this choice (so called “opt-in”).<sup>24</sup>

But more important are the differences between the two laws concerning freedom of contract within their respective system, if they are eventually applicable to a contract:

According to the principal norm in this question, Article 1:102 subsection 1 PECL, the parties may determine the content of the contract “subject to the requirements of good faith and fair dealing”.<sup>25</sup> Article 6 CISG does not contain a similar limitation to the freedom of contract. Further Article 1:102 subsection 1 and 2 PECL subjects the freedom of contract to the mandatory rules established in Article 4:118 PECL (limitation of the exclusion or restriction of remedies for fraud, threats, excessive benefit etc.), Article 6:105 (grossly unreasonable exercise of a unilateral right by one party to decide) and Article 8:109 (exclusion or restriction of remedies for non-performance if contrary to good faith and fair dealing). Article 6 CISG names only Article 12 CISG as the single injunction the parties may not derogate from.

Finally, according to Article 1:103 subsection 1 PECL national mandatory rules are applicable if the law otherwise applicable does not allow their exclusion by the way of choice by the parties, and according to Article 1:103 subsection 2 PECL mandatory rules of national, supranational and international law which are applicable irrespective of the law governing the contract must be given effect. Under the CISG, as far as matters governed by the convention are concerned, no mandatory rule of any national, supranational or international law may be applied - cp. Article 7 subsection 2 CISG. As not all matters are governed by the Convention, mandatory rules are to be given effect whenever a matter is outside the CISG’s scope. According to Article 4 lit. a) CISG the Convention “is not concerned with [...] the validity of the contract or of any of its provisions or of any usage”. So mandatory rules concerning the question of validity can also be applied under CISG. But national mandatory rules remain only applicable by Article 4 lit. a) CISG under the condition that the CISG’s provisions and fundamental principles are taken into account when they are applied to a CISG contract. So,

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<sup>24</sup> Schroeter, please see fn. 20, on p. 258.

<sup>25</sup> Roth/Schubert, in: Münchener Kommentar zum BGB, 6th edition (2012), Verlag C. H. Beck, Munich, § 242, marginal no. 159.

if national law declares clauses as standard terms and conditions invalid because they are incompatible with the essential principles of law from which the contract parties derogate, the relevant essential principles are those of the CISG.<sup>26</sup>

As shown above, the legal nature of the CISG as a contract under international law has allowed its drafters to go beyond the limits laid down in Article 1:102 and Article 1:103 PECL.

## 6. Outlook: Common European sales law

### *6.1. The European Commission's proposal*

October 2011 the European Commission presented a proposal of a Common European Sales Law (CESL).<sup>27</sup> Its concept is that of an optional, collective material law for cross-border sale contracts. That means it can be chosen by the contract parties in addition to national law.<sup>28</sup> The question is, if this could be an option to avoid the control of clauses as standard terms and conditions according to section 305 et seq. BGB (within the German legal system and without complete “escape” to another legal system like e.g. the Swiss one).

### *6.2. Practical significance doubtful*

De facto the possibility of choosing the CESL is not as attractive as it looks at first sight: For contracts between enterprises, it can - according to Article 7 of the regulation proposal - regularly only be chosen if one of the contract parties is a so called “small or medium-sized enterprise” (SME). This depends according to Article 7 subsection 2 CESL on how many employees are employed and that the annual turnover or balance sheet total is lower than a certain sum, but there are no standards mentioned how to determine this sum. This uncertainty even can rise, because Article 13 of the regulation proposal allows the individual

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<sup>26</sup> Schroeter, please see fn. 20, on p. 260 et seq.

<sup>27</sup> COM(2011) 635 final, available at

[http://ec.europa.eu/justice/contract/files/common\\_sales\\_law/regulation\\_sales\\_law\\_en.pdf](http://ec.europa.eu/justice/contract/files/common_sales_law/regulation_sales_law_en.pdf).

<sup>28</sup> In place of many Martinek, in: Staudinger, BGB - Kommentar zum Bürgerlichen Gesetzbuch, Ergänzungsband: Eckpfeiler des Zivilrechts, Neubearbeitung 2012, Verlag De Gruyter; Sellier & Co, Berlin, A. BGB aktuell 2012 / 2013, marginal no. 120.

countries to decide, that within their sphere the CESL can also be used for contracts between two enterprises regardless of their size. In addition, also the CESL contains in its Article 79 in conjunction with Article 86 prescriptions that are similar to those concerning standard terms and conditions in section 305 et seq. BGB,<sup>29</sup> so that it is not sure that German courts really will decide differently but will apply their usual interpretation as under German law.

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<sup>29</sup> Fornasier, please see fn. 4, on p. 29.

Martinek, M. (2012), "BGB aktuell 2012 / 2013", in: Martinek, M. (Ed.), J. von Staudingers Kommentar zum Bürgerlichen Gesetzbuch mit Einführungsgesetz und Nebengesetzen, Ergänzungsband: Eckpfeiler des Zivilrechts, Neubearbeitung 2012, Verlag De Gruyter, Sellier & Co, Berlin, Germany, pp. 1-74.

Roth, G. H. and Schubert, C. (2012), „BGB § 242 Leistung nach Treu und Glauben“, in: Säcker, F. J. and Rixecker, R. (Ed.), Münchener Kommentar zum BGB, 6th edition, Verlag C. H. Beck, Munich, Germany, pp. 95-277.

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# **The Interplay of Flexibility and Rigidity in Russian Business Contracting: The Formal and Informal Framework in Contracting**

SOILI NYSTÉN-HAARALA,<sup>1</sup> ELENA BOGDANOVA,<sup>2</sup>  
ALEXANDER KONDAKOV,<sup>3</sup> OLGA MAKAROVA<sup>4</sup>

Rigidity is a typical feature of contract law, since the cornerstone of contract law is that contracts bind the parties to it. Rigid contract law, however, is a challenge for contractual relations, where flexibility is needed. Russian contract law is rigid even compared to many other national contract laws, although the Russian Civil Code was completely re-written to correspond to the needs of a new market economy in the 1990's. Due to the socialist inheritance, even contracting practices in business are exceptionally rigid. Such a contract culture reflecting strong attitudes of legal centralism leads on the one hand to peculiar ways in circumventing the rigid rules of contract law and neglecting written contract documents in favor of flexible practices on the other.

The article approaches contracts from two different standpoints. Firstly we study how flexibility is introduced in the rigid and formal contract law in the Russian Civil Code and court practice. Secondly we study Russian contract culture through interviews of businesspeople. We analyze our findings through several economic and sociological theories in a multidisciplinary way. The approach to understanding contracts is proactive law regarding contract as a tool in business promoting business goals rather than a legal device.

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<sup>1</sup> Professor of Commercial Law, University of Lapland, Rovaniemi, Finland, and Professor of Jurisprudence, Luleå University of Technology, Sweden.

<sup>2</sup> Researcher at the Centre for Independent Social Research, St. Petersburg, Russia, and Visiting lecturer and PhD student at the University of Eastern Finland, Joensuu, Finland.

<sup>3</sup> Assistant Professor, the European University at St. Petersburg, and Researcher at the Centre for Independent Social Research, St. Petersburg, Russia.

<sup>4</sup> Assistant Professor, Saint Petersburg State University, Russia.

## 1. Introduction

### *1.1. Legal centralist law, multiplicity of norms and contracting cultures*

Contemporary business functions in a global world in an environment of constant changes. Therefore especially long-term business cooperation requires flexibility in contracting. Contract law, however, was created for more stable circumstances and for ordinary sales transactions, in which keeping promises is the main goal, not adjusting to constant changes in the environment. *Pacta sunt servanda* is the strong cornerstone of contract law. Connected with freedom of contract, the wide private autonomy of contract law is supposed to protect the parties, who rely on the binding effect of contracts in their original form.

Classical Continental contract doctrine sees contract as a consent formed through expressions of the free will of the parties.<sup>5</sup> Freedom of contract, which is based on the free will of the parties, allows contracting parties to draft more flexible contracts if they wish to do so. In principle the rigid nature of contract law may even encourage either to introduce flexibility in contract documents or to nourish it in contractual relations.

Lawyers often ignore the fact that contracts are not written for courts and lawyers to interpret the will of the parties. They tend to pay attention only to the legal dimension of contracts and from that standpoint defend the classical interpretation of *pacta sunt servanda*. A court-centered approach, which is anchored to legislation, court cases and legal doctrines and which forgets that contracts are made for business cooperation and that disputes are more often solved outside courtrooms with other than strictly legal rules, is called legal centralism.<sup>6</sup> Lawyers tend to focus only on legally binding rules, which are protected by courts, and ignore all other sets of norms and rules as non-binding. Lawyers generally represent legal centralism, while businesses may have to respect business practices, which may bind them even more effectively than legally binding rules. Even if breaking such rules might not be

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<sup>5</sup> E.g.: Popondopulo, Vladimir F. (1987) *Ob'ektyvnye granitsi, pravovye formy i kriterii klassifikatsii obezatelstv. Problemy grazhdanskogo prava*. Leningrad; Larenz, Karl (1989) *Allgemeiner Teil des deutschen Bürgerliches Rechts. Ein Lehrbuch* 7, 515. Aufl. Verlag C.H. Beck. München; Hemmo, Mika (2006) *Sopimusoikeuden oppikirja*. Talentum, Helsinki, 31.

<sup>6</sup> See: Galanter, Marc (1981) *Justice in Many Rooms. Courts, private ordering and indigenous law*. *Legal Pluralism* 19 (1981), 1-47; Nysten-Haarala, Soili (1998) *The Long-term Contract. – Contract law and contracting*. Finnish Lawyers Publishing, Helsinki.

sanctioned in courts, losing reputation in business may be a more effective sanction. Legal sociologists and anthropologists pay attention to the multiplicity of different sets of rules, which seems to increase in global business. Businesses have to cope with global, national and local rules, which may contradict each other.<sup>7</sup>

The plurality or multiplicity of norms has also been recognized in legal studies. Private international law has always dealt with the conflict of laws, which traditionally focuses on which country's law is applied in international legal problems between companies or individuals. Nowadays there is also a discussion on *lex mercatoria* or New Merchant Law, focusing on the need to accept international principles and rules (UNIDROIT Principles, Principles of European Contract Law (PECL) and alike) as sources of law in court decisions.<sup>8</sup> The circle of international commercial lawyers already applies such sets of rules in private arbitral tribunals. It can be claimed that international business contract law resembles an international legal system, while national contract laws are only variations of it. Even this international contract law reflects legal centralism, but with a universal approach. It emphasizes similar features in national laws and promotes unification or harmonization of contract law.<sup>9</sup>

The principle of freedom of contract promotes the multi-regulatory environment of international business. National contract law, such as the Russian Civil Code is mostly non-mandatory; such default rules are applied only if not otherwise agreed in the contract. Although there is also a growing tendency towards an increase of mandatory norms, which protect either consumers or competition on the market, businesses have alternatives in choosing the law and regulations, which are applied to their contracts.

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<sup>7</sup> Cf. the discussion on global legal pluralism e.g. Teubner, G. (1992) *The Two Faces of Janus: Rethinking Legal pluralism*. *Cardozo Law Review* 13, 1443-1451; Teubner, Gunther (1997) *Global Bukowina: legal pluralism in the world society*. In Teubner (ed.) *Global Law without a State*. Dartmouth Aldershot, 3-28; Michaels, Ralf (2005) *The Re-State-ment of Non-State Law: the State, Choice of Law, and the Challenge from Global Legal Pluralism*. *Duke Law School Legal Studies Research paper Series*, No 81 (September 2005). Available at <http://ssrn.com/abstract=809244> (accessed 26 August 2014); Berman, Paul Schiff (2005) *From International Law to Law and Globalization*. *Columbia Journal of Transnational Law* Vol. 43(2), (2005) 485-556.

<sup>8</sup> See e.g. Berger, Klaus Peter (2010) *The Creeping Codification of the New Lex Mercatoria*. *Kluwer Law International*; Von Bar, Christian and Mankowski Peter (2003) *Internationales Privatrecht*. Band 1. *Allgemeine Lehren*. 2 edition. Beck München.

<sup>9</sup> See e.g. Lando, Ole (2007), *Is Good Faith an Over-Arching General Clause in the Principles of European Contract Law?* *European Review of Private Law*, Vol. 15(6), 1687-1725; Berger, Klaus Peter (2010) *The Creeping Codification of the New Lex Mercatoria*. *Kluwer Law International*.

Contract culture, however, is more difficult to avoid than the provisions of contract law. Every industry or commercial branch has its own standards, which sometimes can be commercial usages or trade customs. Even they can be set aside agreeing otherwise in the contract. Multinational corporations often tend to introduce their own contracting practices to their business partners with their own contract templates. The rise of American contracting practices with long and detailed contract documents is proof of such a worldwide phenomenon.<sup>10</sup> In spite of such development of a more technical and formal nature, informal contracting practices such as thinking modes and working habits may be more difficult to avoid or set aside in practice, since they are cultural and unconscious.

Douglass North's institutional economics gives a good explanation for the difficulties encountered even by huge influential multinationals in tackling with local habits and thinking modes. They are informal rules of the game, while laws and formal contracts are formal rules of the game or formal institutions.<sup>11</sup> Formal institutions were in Russia changed very quickly simply by drafting a new Civil Code with new values of a new market economy. Change in the formal rules of the game does not, however, change the informal rules such as habits in contracting and ways of approaching contracts and contractual liabilities. These habits may carry unconscious cultural values from earlier times. Since Russia is a country with strong informal institutions and weak formal institutions,<sup>12</sup> unconscious informal rules of the game are important also in contracting.

Sociologists and anthropologists have paid attention to latent and not articulated communication and other cultural dimensions of contracting.<sup>13</sup> Edward T. Hall suggested distinguishing low-context and high-context cultures. In high-context cultures many things

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<sup>10</sup> Professor Giuditta Cordero Moss's research group at the University of Oslo has studied this phenomenon especially from the point of view of contract clauses (see <http://folk.uio.no/giudittm/AngloAmerican%20Contract%20Models.pdf>).

<sup>11</sup> North, Douglass C. (1990) *Institutions, Institutional change and economic performance: A new Economic History*. Cambridge University Press;

North, Douglass C. (2005) *Understanding the process of institutional Change*. Princeton University press. Princeton, New Jersey.

<sup>12</sup> Rose, Richard (2000) *Getting Things done in an Anti-modern Society: Social Capital Networks in Russia* in Dasgupta P. and Seragelden I. (eds.) *Social Capital*. Washington D.C. World Bank, 147-171.

<sup>13</sup> Hofstede, Geert (1983) *Culture's Consequences: International Differences in Work-Related Values*. *Administrative Science Quarterly*, December 28 (4), 625-629;

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are left unsaid and require cultural context to illuminate the meaning. North America and Western Europe are regarded as low-context cultures, which value logic, facts and directness, while high context cultures in Asia, Middle East, Africa and South America are relational, collectivist, intuitive and contemplative emphasizing interpersonal relationships.<sup>14</sup> In more recent research based on fieldwork, John Hooker divides cultures as rule-based or relationship-based and thus assumes a continuum between different cultures that result from multiple combinations of features of both types of cultures.<sup>15</sup> Even the most typical examples of rule based cultures also have a relational dimension of contracting as Macaulay (1963, 1985) and Macneil (1974, 1978) have shown.<sup>16</sup> Cultural or business cultural dimensions can be important especially from the informal and relational point of view and can reflect on the reputation of companies even without legal sanctions.

Contracting can and should in practice be approached from many different standpoints. There are;

- 1) more or less global rules of the game of the industry;
- 2) organizational culture and rules;
- 3) more general cultural rules of the area; as well as
- 4) national, international or even local formal rules and regulations.

They all frame contracting and contract documents.

## *1.2. Approach and Method*

The typical understanding of contracts as legal documents, which should be left for lawyers and hidden in a safe box, is an example of informal institutions, which have developed during

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<sup>14</sup> Hall, Edward T. (1976) *Beyond culture*. Garden City, NY: Doubleday.

<sup>15</sup> Hooker, John (2012) Cultural differences in Business Communication. In Paulston, C. B., S.F. Kiesling and E.S. Rangel (eds.) *Handbook of Intercultural Discourse and Communication*. Wiley.

<sup>16</sup> Macaulay, Stewart (1963) Non-contractual relations in business: a preliminary study. *American Sociological Review*, Vol. 28, 55-67; Macneil, Ian (1978) Contracts: Adjustment of long-term economic relations under classical, neoclassical and relational contract law. *Northwestern University Law Review*, Vol. 72, No 6 (Jan-Feb 1978), 854-905; Macaulay, Stewart (1985), *An Empirical View of Contract*. *Wisconsin Law Review* 1985, 465-482. Macneil, Ian (1974), *The Many Futures of Contract*, 47 *Southern California Law Review* p. 691-816.

a long period of time in business. It shows how strong the influence of legal centralism is, since it has managed to colonize contract documents on behalf of lawyer-master taken out of the hands of the real users of contract. The wider perspective, which we apply in our study, represents proactive law paying attention to improving business contracting in order to better serve business purposes and avoid unnecessary disputes, especially disputes, which are taken to courts.<sup>17</sup>

Contracting in proactive law is seen as organizational capabilities, which can be improved.<sup>18</sup> Nysten-Haarala and her research project detected three intertwining dimensions of contracting capabilities, namely content, process and relational. Content capabilities are directed to planning and choosing the content for contract documents. Content capability is not just a legal skill to draft and choose contract clauses, but a wider capability in understanding the environment of contracting and the multiplicity of norms around the contract and affecting the contents. Process capability refers to organizational processes and technical contract management in an organization. Relational capabilities are negotiation and communication skills, which are important from the point of view of informal rules of the game (CCC report 2008).

The more precise objective of our research is to find out how flexibility is introduced in contracts in an environment of rigid contract law and rigid formal practices of drafting contract documents. First, however, we present the framework of formal and informal rules of contracting. The formal rules are the national Civil Code of the Russian federation<sup>19</sup> compared with the Convention on the International Sale of Goods (CISG) which in Russia is

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<sup>17</sup> Siedel, George. J. & Haapio, Helena (2011) *Proactive law for Managers: a hidden source of competitive advantage*. Gower Publishing Company; Haapio, Helena (2006) *Introduction to Proactive Law from a Business Lawyer's Point of View*. In Peter Wahlgren (ed.) *Scandinavian Studies in Law. A Proactive Approach*. Stockholm Institute for Scandinavian Law, Vol. 49. Stockholm, 21-34.

<sup>18</sup> Cf. Argyres, N. & Mayer, K.J. (2007) *Contract design as a firm capability: An integration of learning and transaction cost perspectives*. *Academy of Management Review*, Vol. 32, No 4 (Oct 2007), 1060-1077; Teece, D.J. (2007) *Explicating Dynamic Capabilities: The Nature of Microfoundations of (Sustainable) Enterprise Performance*. *Strategic Management Journal*, 28 (13), 1391-1350.

<sup>19</sup> The first part of the CC covering the general rules of the law of obligations came into force in 1994, the second part covering regulations of specific types of contract in 1996.

applied to contracts of international sale of goods<sup>20</sup>. The Civil Code applies to domestic sale of goods or services and also fills the gaps of the CISG as secondary legislation.

In the second part of the study we advance to the application of formal rules and their interplay with informal rules through semi-structured qualitative interviews. Interviews were conducted in St. Petersburg in 2012 and 2013 in one German-Swedish company working in transportation, one Finnish company working in services and an American company working as a franchising chain in technology industry. The companies represent large and medium sized business, which have a history of working in Russia for at least three years. The names and concrete activities of these companies are obscured to protect their interests and standing in the market.

The case studies included interviews with managers and lawyers of the companies, a study of the history of the companies' operations in Russia, and an analysis of significant documents such as corporate codes of ethics; plus disputes in courts with these companies as a defendant or a claimant (2011-2012). Experts and informants were encouraged to answer freely without any standard options of answers. The free interview form allowed researchers to receive answers that reflected the interviewees' own cognitive and mental constructions, in this case providing insights into how economic actors understand the problems of international cooperation and ways of solving them.

We also interviewed a Finnish consultant, who operates in Russian markets advising Finnish companies. In the analysis we also refer to earlier interview studies of Finnish companies importing wood from Russia and their Russian partners. These interviews were also semi-structured and were conducted in 2004 – 2005 in Finland, St. Petersburg, Petrozavodsk and Arkhangelsk. They have been reported in an article “Contract Law and Everyday Contracting” published in 2006. Although the companies of this earlier interview study represent a different business branch and only trade with Finnish partners, they indicate how contracting practices have developed or not developed during the timeframe of the last ten years.

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<sup>20</sup> The CISG is already some kind of a world-wide law in international sale of goods. It has been ratified in 78 countries and can be applied even when there are parties from countries, which have not ratified the convention (CISG, Article 1).

Besides our own interviews, we also refer to the rare empirical studies, which other researchers have made in Russia and reported in literature.<sup>21</sup> Based on both our own interviews and findings of this other empirical research, we also study the role of corporate lawyers in business as well as the role of courts in Russian business.

## 2. The formal legal framework of contracting

### *2.1. The origins of Russian civil law and tight control*

In the legal family classification of comparative law, Russian law belongs to the family of continental civil law systems. German BGB was the example for the first Soviet Civil Code in 1922 as well as for the Civil Code of 1964. The concepts and the style of codifying law originate from Germany, although the main institutions of civil law, such as private property and freedom of contract became less significant in soviet civil law. Property rights were weak even before socialism, the long tradition of which still obscures the Russian economy. Contract law in the socialist planned economy became administrative by nature, since contracts were made based on the state economic plans and functioned to fulfill these plans. Contracting parties could not freely draft contractual clauses, but were tied to instructions from above. Yet, in our opinion Zweigert and Kötz are right in understanding that socialist law was never as socialistic and as different as the Marxist scholars made it seem.<sup>22</sup>

Planned economy was an attempt to abolish the markets, but it actually prompted a parallel shadow economy to fill in the gaps of the official planned system. The official economy answered with tighter control, which the shadow economy again circumvented.<sup>23</sup> Red tape and arbitrary control of authorities were typical features of Russian administration already before the revolution.<sup>24</sup> Weak formal institutions allowed red tape and arbitrary control to continue and accordingly become an essential part of the society's structures, which informal rules of the game then support. This indicates that modernization has not been completed in

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<sup>21</sup> e.g. Murrell, Peter (ed.) *Assessing Value of Law in Transition Economies*. Ann Arbor. The University of Michigan Press 2001.

<sup>22</sup> Zweigert, Konrad and Hein Kötz (1998) *Introduction to Comparative Law*. Translated by Tony Weir. 3 edition. Oxford University Press.

<sup>23</sup> Hosking, Geoffrey S. (1985) *A History of the Soviet Union*. Fontana Press.

<sup>24</sup> This can be detected from e.g. Nikolai Gogol's novels and short stories, which are written with a satirical style, but are clearly based on real life phenomena.



Russia and the level of the Weberian formal rationality not been reached in economic administration.

When the Soviet Union collapsed, civil law and its historical roots did not disappear. The new Civil Code of the Russian Federation was drafted by lawyers, who represent the Soviet tradition.<sup>25</sup> The concepts and doctrines are of German origin and are still based on will theory, juristic act, subjective rights and the like.<sup>26</sup> The drafters actively searched models for law for a new Russian market economy from European and American, both civil law and common law legal systems. Transplants from Western market economy systems were adopted, but nobody was truly able to anticipate how a new market economy would work in practice. Drafting of new laws was strongly lawyer-driven, and lawyers in all legal systems are typically unaware of economic and social dimensions of society operating only under legal concepts.<sup>27</sup>

Traditional ideas of the need for tight state control can be found in a many requirements of formal procedures, which are considered as safeguards for actors in the market. One typical safeguard is the requirement of a written form of contracts. According to the Civil Code of 1994, oral contracts were valid only between citizens and with the value less than 10 minimum wages<sup>28</sup> and most contracts required notarial proof or registration (Articles 158-165 GK). After the recent reform of the Civil Code which entered into force from September 1, 2013 (FZ 07.05.2013 N 100-FZ) the minimum value for oral contracts rose up till 10. 000 rubles except for contracts, which based on legislation require a written form. The requirement for registration was limited only to transfer of ownership of immovable

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<sup>25</sup> Members of the group preparing for the Civil Code, which Braginsky's and Virtyanski's commentary book (1999) mention, such as A.L. Makovskij, G.E. Avilov, S.S. Alekseev, G.D. Golubov, V.A. Dozortsev, Ju. H. Kalmykov, O.M., Kozyr', E. A. Suhanov and S.A. Hohlov were influential legal scholars already in the Soviet Union.

<sup>26</sup> The above mentioned commentary book also mentions by name several prominent soviet legal scholars, whose works in the opinion of Braginski and Vitryanski could have been published in any other country, including non-socialist countries. This opinion shows how strong the influence of the German legal doctrine and law scholars' internationally narrow approach to law as the system of legal rules was and still is.

<sup>27</sup> See *supra* 25

<sup>28</sup> A minimum wage as a calculative measure is only 100 rubles. The maximum value of an oral contract was earlier about 22 euros or 30 US \$. (5.9.2013) and now rose up till 2.200 euros or 3.000 US \$.

property.<sup>29</sup> Although formal requirements have been diminished, there still are many requirements for permissions thus allowing strong control of the authorities.

## *2.2. Commercial usages*

The Civil Code commentary of Vitryansky and Braginski clearly indicates that the lawyers who were preparing the Civil Code were consciously making the rules of the game for business, not just enabling a framework for business. One clear indication of this legal centralist mentality is that commercial usages cannot be applied if they are not stipulated in legislation (Article 5.1. GK). In principle this did not mean that a commercial usage had to be clearly mentioned in the Civil Code, but that it could somehow have been interpreted as corresponding to legislation. In practice, compared with the CISG this requirement gave commercial usages a lower position in the hierarchy of legal sources which can be interpreted by courts.<sup>30</sup> This regulation clearly differs from international contract law, where “commercial usages, which the parties knew or ought to have known and which are widely known and regularly observed in the particular trade concerned, can be impliedly applied to the contract” (CISG art 8). Besides an extreme legal centralist attitude, this difference in Russian domestic contract law may also have reflected a suspicious attitude towards commercial practices in domestic business, which either originated from administrative practices of the soviet economy or from the earlier criminal shadow economy.<sup>31</sup> These early business practices were not regarded among lawyers as being fair, therefore a measure test with the Civil Code seemed a logical idea in order to sweep out undesired practices.

In the recent change of the Civil Code<sup>32</sup> this stipulation was clarified to refer only to business practices, which are not established commercial usages. Such practices even if they are widely spread in business or adopted in contracts are not legal in case they contradict with

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<sup>29</sup> The concept of immovable property is rather wide in Russian law; including land property and buildings even on state owned land. Even vessels (ships, aircrafts and space related vessels) are immovable property (CC article 130)

<sup>30</sup> Braginskij, M. I and Vitryanskij V. V. (1999) *Dogovornoe pravo. Kniga pervaya. Obshnie polozheniya*. Moskva: Statut, (p. 72-71).

<sup>31</sup> The supremacy of trade usages may also be a threat to business. According to Lisa Bernstein's recent research courts tend to accept almost any practice as a trade usage with very weak proof. (see. Bernstein (forthcoming in 2014)).

<sup>32</sup> (07.05.2013 N 100 –FZ).

norms of behavior, which are presupposed by legislation. Business practices can be regarded as illegal, but this regulation is actually targeted only towards wild practices, which contradict mandatory legislation.

### *2.3. Standard contracts*

The attitude of civil law to standard contracts is also influenced by the Soviet past. In the planned economy there were many standard templates, which were introduced through legislation and/or used by state enterprises. Present Civil Code recognizes such contracts as model contracts (*tipovye dogovory* art 426) required by law and issued by the Government of the RF or federal organs authorized by the Government. These templates are used in situations where the public entity having a monopolistic position in the market is forced to make a contract, because the other party has no alternative partners for concluding the contact with. Such templates are also in use under the Consumer Protection Act. Nowadays, the amount of such contracts has, however, diminished considerably.

The Civil Code also regulates so called General Model Conditions (*primernye usloviya* art 427). The only requirement under the Civil Code for these general conditions is that they should be published in press. Any commercial company can develop a model contract, publish it in press and in this way prove that the model is publicly known. Such model contracts can be referred to in a contract in order to make them a part of the contract. According to the Civil Code such standard contracts can also have a status of commercial usages. The text book of Braginsky and Vitryansky identified an abundance of all kinds of published models. Book stores are full of collections of templates, which are often quite plain and cover only provisions, which are required by default rules of the civil code. The civil law commentary points out that these collections of templates have a different function than model contracts, which are based on legislation, confirmed by the government and issued by a ministry or a corresponding authority.<sup>33</sup> Many published templates can, however, be used as some kind of checklists in order to control that the provisions required by legislation are included in the document.

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<sup>33</sup> Braginskij, M. I and Vitryanskij V. V. (1999) *Dogovornoe pravo. Kniga pervaya. Obschie polozheniya*. Moskva: Statut, (p. 79).

The Civil Code regulates in article 428 (*dogovor prisoeineniya*) how standard contracts become binding between contracting parties. This article regulates contracts in which one party is in “a take it or leave situation” such as consumers in concluding insurance contracts, contracts with banks or e.g. a lease contract in St. Petersburg. The Civil Code gives an opportunity to ask the court to terminate such a contract even if it does not contradict any legislation but only diminishes his rights in an unfair way compared to the contents of default rules. The unfair conditions of the contract have to be such that the consumer would not without the “take it or leave it”-situation have accepted them. The above mentioned regulation does not, however, protect parties to a B2B contract.

Standard contracts recommended by industrial organizations, such as ORGALIME or NL contracts, which are widely used in Europe, are not yet well known in Russia. International trade has, however, brought these standard contracts to Russia, as well, because international contracting parties may suggest them to be used. Limitations of seller’s liabilities, which are characteristic to these standard contracts, may be confusing for Russian contracting parties and even lawyers, but there is no legal obstacle in using them in B2B relations.

#### *2.4. Interpretation of Contracts*

The Civil Code, which is officially proclaiming freedom of contract (Article 421) on the one hand, wants to control business on the other. Even rules of interpreting contracts differ in Russian domestic contract law (Article 421) from international contract law – in the form of the CISG (Article 8), which is applied to contracts of international sales even in Russia. In the CISG:

“the starting point of interpretation is the intent of the parties, or if that is not possible to the understanding that a reasonable person of the same kind as the other party would have had in the same circumstances.” These are interpreted through “all the circumstances of the case, including the negotiations, any practices, which the parties have established between themselves, usages and any subsequent conduct of the parties.”

In more formal Russian law, the written text of the contract document is the starting point, which can then be complemented with other material such as negotiations, other oral

expressions, commercial usages and established practices of the parties. If the written contract is unclear, other conditions and the aim and spirit of the contract as an entirety will contribute to the interpretation (Article 431 GK). Written expressions are emphasized because of their value of proof in courts. The entirety of contract is certainly more difficult to prove in Russian courts, which do not prefer oral proof to a written document.

### *2.5. Requirement of a Written Form of Contracts*

The recent change of the civil code abolishing the earlier requirement of the written form from international sales contracts is quite radical.<sup>34</sup> Soviet Union was one of the countries, which required a reservation to the CISG making written form of contract obligatory for contracts with one of the parties from a country, which joined the reservation (Article 96 of the CISG). Now Russia has abandoned the reservation and from September 1, 2013 even oral contracts are valid in international trade. On the one hand, this change takes Russia closer to the CISG community in international trade, but on the other widens the difference between domestic and international contacts. The warnings of Russian text books from applying domestic rules to international contracts and their emphasis on the many differences in interpretation of international sales contracts compared to domestic contracts, are still valid.<sup>35</sup>

Written contracts are still recommended in international trade, because they are a handy proof of the content of the contract in courts. On the other hand state authorities control contracts, which for this purpose need to be in a written form. The difference which the change in law makes is that written contracts do not necessarily have to be changed with every price reduction or other minor change. The authorities cannot claim that the changes are invalid, if they are not made in a written form. Proving the new content of a contract, which exists in an oral form, may, however, be demanding. Thus, price reductions and other similar changes are still recommended to be made in a written form.

The customs office controls contracts of import and export. The amount of goods mentioned in the document has to correspond with the real amount. The banks have to control that the

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<sup>34</sup> (07.05.2013 N 100 –FZ)

<sup>35</sup> Rozenberg, Mikhail .G. (2003) *Mezhdunarodnaya kuplya-prodazha tovarov. Kommentarii k pravomy regulirovaniyu i praktike razresheniya sporov*. Moskva: Statut, (p. 31).

payments correspond to the contract price. Tax authorities can arrange a raid to the premises and check all the contracts. In such circumstances formal contracts are written for the state authorities not for the parties themselves. Contract documents cannot be devices of communication between contracting parties, as proactive law suggests, because they serve for other purposes.<sup>36</sup> A contract document is more like an official façade for a contractual relationship rather than a document reflecting the real relationship. A formal contract is not written only as the potential safeguard of the court as in the Western countries, but to satisfy all the authorities, who require that the formal rules of the game be followed.

Sale of goods contracts can avoid Russian contract law provisions almost totally. The CISG governs international contracts, although it can also be excluded and other national laws chosen instead (Article 6 of the CISG). Yet, the CISG does not apply to services (Article 3)<sup>37</sup> or all goods (Article 2), furthermore it does not apply to all the problems. The CISG does not cover invalidity of contracts, authorization, or property rights (Article 4). These have to be covered by secondary legislation which if not otherwise agreed depends upon the rules of private international law. According to those rules, the secondary legislation can be Russian law or the law of the other party of the contract. The secondary legislation can also be agreed in the contract, as well as the site of dispute resolution be moved out of Russia. Domestic contracts with parties, whose places of business are in Russia, are covered by the Russian Civil Code. A foreign owned company which is registered in Russia is a domestic company.

## *2.6. Rules of Invalidity of Contract*

Invalidity of contracts is an interesting aspect of Russian civil law (Articles 166-181 GK). According to the Civil Code a contract can be invalidated based on formal mistakes, mandatory legislation, lack of authority and flaws in the formation of will such as fraud, physical or psychological duress and error irrespective of motive. An error can be found also in not understanding the aim of the contract. Furthermore a fake contract or a contract

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<sup>36</sup> Nystén-Haarala, Soili (2006) *Contract Law and Everyday Contracting*. In Peter Wahlgren (ed.) *Scandinavian Studies in Law. A Proactive Approach*. Stockholm Institute for Scandinavian Law, Vol. 49. Stockholm, 263-283.

<sup>37</sup> Actually the CISG can in some circumstances be applied also to services if they are additional to a sales contract. Interpretation of article 3 of the CISG is, however, quite unclear.

established against legal principles and ethics can be invalidated. The latter rules certainly give a lot of room for interpretation.

The Russian Civil Code also includes a very peculiar reason for invalidity, which is that the contract has been concluded against the aims of the company declared in the company's founding documents (Article 173 GK). Earlier anyone could ask for invalidating a contract based on this rule, and often state authorities interfered in contracts based on this rule. After the changes of 2013 only the organization itself, its founder or someone in the organization can ask for invalidating the contract based on it contradicting the aims of the company if it can be proven that the other party knew or ought to have known that the contract was contrary to the aims and purposes of the company.

In principle invalidity is in all legal systems a grave exception, which leads the contract being interpreted as never having existed. In Russia, however, the courts have often interpreted invalidity quite broadly, especially when the authorities are involved. Therefore invalidating contracts has become a tool in getting rid of unprofitable or otherwise bad contracts as well as a tool for authorities' arbitrary interference. Since formal requirements, such as notarial certificates or various licenses are many, and interpretation of other grounds for invalidating a contract wide, it is easy to find or even deliberately leave an option in the document for later invalidating the contract in case everything does not work as it was planned. Companies, who change their minds and do not want to cooperate any more, have been able to find loopholes in for instance defining the essential terms of contracts, and manage to get the contract declared invalid in court. Rigid rules start to work in a contradictory manner, when they are used for circumventing the otherwise binding contract.

The recent reform of the Civil Code tries to limit the possibilities for using rules of invalidity in bad faith, excluding it from a party who was not in good faith, especially if his behavior leads the other party rely on the validity of contract. It remains to be seen, how often absence of good faith and deliberate causing of invalidity can be proven in courts. By law protected threatened interests of a third party, can also lead to invalidating a contract. Even after the reform, the authorities were left with opportunities in interfering contracts. The Civil Code stipulates that if public interests or other interests protected by law are threatened, the court can from its own initiative declare the contract invalid. In other cases only the parties to the contract can claim for invalidity.

Invalid contract were earlier null and void as such, while now the civil code applies the term “disputed” (*osparimaemyi*) making validity of such contracts dependent on the parties. If the contracting parties do not claim for invalidity, the contract stays in force.

In the data collected about the three case study companies, we found several legal disputes in *arbitrazh* courts (during 2011-2012).<sup>38</sup> Most of the cases, which we found in the Russian database of *arbitrazh* courts concerned foreign owned companies claiming for a payment from their Russian clients. In almost all of those cases the Russian defendant claimed that the contract is invalid. Even if in none of those cases such counterclaims were accepted, claiming for invalidity indicates that it is an ordinary tool in a litigating lawyer’s toolbox and may sometimes work. The new amendments of the Civil Code should close some of these loopholes and decrease the amount of artificial and unjustified invalidity claims.

This is not the only case in which loopholes are identified and then mended. Law in Russia is often misused creatively for purposes that it was not meant for. The misuse of minority shareholders’ rights and bankruptcy legislation in hostile takeovers is one such phenomenon<sup>39</sup> and introducing corruption with the help of anti-corruption rules is another.<sup>40</sup> The legislator can never know in advance, which legislation is going to be misused and how to close the loopholes for good. New loopholes will definitely be discovered as soon as the old ones are mended. This kind of flexibility is harmful for the whole credibility of the legal system, which cannot protect business from misuse of law. Unfortunately, the tendency to circumvent law also affects on the wording of legal text and makes it excessively complicated.

## *2.7. Changed Circumstances and Early Termination of Contract*

Flexibility in law is often connected with the regulations concerning changing circumstances. The original model for drafting changed circumstances has for civil law countries, which follow the German tradition, been the BGB 242 general clause of good faith (*Treu und*

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<sup>38</sup> *Arbitrazh* courts (*arbitrazhnyisud*) are not private arbitral tribunals in Russia, but state courts for commercial and business related disputes. Private arbitration is called *treteyskiy sud* in Russian. *Arbitrazh* courts and ordinary courts are now being merged in Russia to a unified court system.

<sup>39</sup> Matilainen, Anna-Maija (2009) *The Struggle for the Ownership of Pulp and Paper Mills*. In Nystén-Haarala, S. (ed.) *Changing Governance of Renewable Natural Resources in Northwest Russia*. Ashgate. Farnham, 105-128.

<sup>40</sup> Tulaeva, S. (2011) *How anti-corruption laws work in Russia*. *Russian Analytical Digest* 92.



*Glauben*). More recent civil codes of European countries as well as international principles of contract law have paid attention to regulating the effect of changed circumstances in contracts. The Russian Drafting Committee of the Civil Code seems to have looked at the UNIDROIT (Articles 6.2.1. – 6.2.3.) principles in developing exception rules of the article 450 of the Civil Code. Traditionally changing circumstances can lead to termination of contract in very rare cases, since it is required that changes in circumstances are mostly foreseeable and assumed that contingencies can be anticipated with contracts. The main rule in article 450 reflects this idea: “One-sided termination of contract in the absence of a contractual provision allowing it is possible only if there is a significant breach of contract or if it is provided by law. A significant breach of a contract is such that the other party to a significant extent loses what he was entitled to in the conclusion of contract.” (Article 450)

Contracting parties can together quite freely stipulate on a termination clause. The length of the termination period can also be agreed, but in the absence of it, the minimum length of the termination period is thirty days (Article 452). Special legislation can stipulate on longer termination periods, e.g. in case of lease or rent contracts. Legislation also allows special reasons for claiming for one-sided termination of e.g. lease contracts.

The CISG does not contain a stipulation similar to Article 450 GK, but does permit termination in “*impediment beyond control*” either temporarily or permanently. If nothing else is agreed in the contract, only natural disasters or decrees of state authorities making the contract impossible to perform, are accepted in courts as grounds for non-delivery (CISG Article 79). The Russian domestic regulation is similarly strict calling the impediment the force, which could not have been prevented. A contractual clause, in which the grounds for non-delivery are regulated, is called a *force majeure* clause. Based on either a force majeure clause or Article 79 of the CISG or the Civil Code Article 401, the delivery may be postponed or the contract terminated.

The CISG does not recognize economic *hardship*, but in more recent contract law and in some international collections of principles changing economic circumstances (hardships) may lead to modification or termination of contract. In UNIDROIT Principles hardships lead to renegotiations, after which the court can free the other party from liability, if the renegotiations fail (Articles 6.2.1. – 6.2.3.). Russian civil code has borrowed the requirements of early termination or modification from UNIDROIT principles, but not the possibility for

the court to urge the parties to renegotiate. The Principles of European Contract law mention circumstances which have become too onerous for a contracting party (Article. 6.1.1.).

These international principles are not binding legislation, but they can be chosen to be applied to contracts. International arbitrators often try to find assistance in them even if they would not bind the parties. Hardship is an example of non-binding regulations, which in the New Merchant law discussion is urged to be accepted as legally binding rules in disputes on international commercial contracts.

Finnish and other Nordic contract laws allow unfair contracts to be modified or terminated if circumstances have become unfair or if the stronger party already from the beginning has misused its power to make the other party conclude an unfair contract (Nordic Contracts Acts 36§). This tool, which now is interpreted to be applied also in hardship case, is applied very cautiously in courts, especially when it comes to business contracts. Consumer protection may, however, allow modification of a contractual provision, which is unfair to the consumer. Some other countries, such as Germany or France have black lists of illegal unfair terms of contract. The result of applying those rules is usually similar to the modification of unfair contracts in the Nordic countries.

The Russian Civil Code adopted a possibility to ask for termination or modification of a contract in court owing to significant changes of circumstances. This article 451 is not only a hardship rule, since it can in principle be applied in all significant changes of circumstances where if the other party had foreseen the circumstances, that person would not have concluded the contract. Four additional conditions must be fulfilled before the court can adjust or terminate the contract. Firstly, the change has to be such that the parties could not have foreseen it when the contract was made. Secondly the change could not have been overcome with the carefulness and diligence which is characteristic for similar contracts. Thirdly, the performance of the contract without changing it would violate the balance of property interests of the parties and involve the interested party such a damage that he would have considerably lost what he was entitled to expect at the conclusion of the contract. Fourthly, the court has to check that there is not an established trade custom of risk-sharing to be applied to the case.

Although this provision has existed from 1994 in the Civil Code, the courts have not applied it, although Russian economy has experienced drastic changes - or perhaps exactly because of them. Text books treat article 451 in a very abstract manner<sup>41</sup> or not at all.<sup>42</sup> In a commentary from 1996 it is mentioned, however, that for instance such a change in the currency value of the Russian ruble that the stock market crisis in 1994 (11.10.1994) represents, could not have been foreseen.<sup>43</sup> Although the economic depression of 1998 could also have fulfilled the requirements of article 451, there were no cases in courts claiming for modification of contracts. It has never been tried at the Highest Court of Arbitration. The reason may be that modification is too new and strange for Russian lawyers. Disputing parties seem to find it easier to try and claim for invalidity instead of trying to apply the article 451.

### 3. Contracting practice

#### *3.1. Control of Authorities*

Contracting culture in Russia is rooted in the socialist past, when contracts were devices of control in fulfilling the state economic plans. Contract document became formal and rigid, something similar to official state documents. The public sector red tape contaminated contracts with excessive rigidity. When Russia in the beginning of 1990s became a market economy, the red tape practices spread also into business. This quite large formal part of business is administrative by nature. Contract documents are connected with bureaucratic red tape and they require formality.

The nature of state control is well indicated in the following quotation of a Finnish manager running a company in Russia:

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<sup>41</sup> Kommentarij chasti pervoj grazhdanskogo kodeksa Rossijskoj Federatsii dlya predprinimatelej (1996) Red. V Kuznetsov and T. Braginskij. Redaktsiya zhurnala khozyaistvo i pravo. Moskva.

<sup>42</sup> Braginskij, M. I and Vitryanskij V. V. (1999) Dogovornoe pravo. Kniga pervaya. Obschie polozheniya. Moskva: Statut.

<sup>43</sup> Comment of the Civil Code of the Russian Federation (part I) (Article-by-article)/Edited by Sadikov O. N. M., 1997.

You need to get a bunch of approvals: one should approve, then another, then a third person has to make his verdict and so on. There was a funny case, while we tried to get the approval, 1,5 years passed.<...>So while we were collecting all the necessary documents in various committees: the committee on urban planning, historic and architectural committee, etc.; waiting for all the possible permits, resolutions and approvals; the head of, I don't remember which instance, it was one of departments of administration of the area X in St. Petersburg, he was replaced by another person. And when we brought all the documents, he didn't approve it and just said: "I can't believe that you have all the required permits." And we had to talk to this person for a very long time without bribes or something like this, and finally we got his approval. The funniest thing is that on the following day after we received his permission, the ordinary officers of Road Police came to our premises and started asking, who is the boss here and why did we put the terrace? And they were really surprised when, instead of calling to some authorities, we showed them all the required documents and permits, saying to them: "Look, all our documents are legal, we have all the required permits." (manager\_Fin)

This example is quite typical and revealing and shows that the control of authorities is strict, but arbitrary. Therefore, conduct of business strictly according to the rules may confuse the authorities, since Russian business often choose to find faster, but more risky informal ways with dealing with permissions. Confusion of authorities indicates that informal institutions are strong and used for other than strictly control purposes. The following quote demonstrates how foreign businessmen, who come from low-context cultures and countries, where formal institutions are strong, would understandably prefer transparency and legality in governmental control:

It would be much better if the rules of the game were more open and obvious. Our ability of managing our business will depend on governmental control, and we hope that joining the WTO will change this situation. (manager\_USA).

### *3.2. The Need for a Reliable Assistance*

Since formal institutions are weak, foreign business needs to know, how the informal practice works. For this purpose they need someone, who is reliable and knows how to deal with

governmental authorities and business partners, but does not get the company in trouble with the legal system and authorities.

I think it should be a person who is both honest and knowledgeable in the business sphere. Anyone who has opened a business there [in Russia] says that it is the most important thing. You have to find an honest man, and you know that this is the most difficult aspect--to find such a person. (expert\_develop).

When the foreign company does not operate directly in the Russian markets, but only exports products, it is easier to leave dealing with Russian authorities to their Russian cooperation partners. Finnish forest companies preferred to use small Russian entrepreneurs to deal with the authorities on the Russian side of the boarder, and sometimes not even care, how they managed to find ways out by using informal methods. Closing one's eyes is more difficult when the company is already established in Russia. It may also be dangerous even when the company operates from the home base. The example of Stora Enso being blamed for illegal loggings in Russian Karelian forests is quite revealing. A contract with the sub-contractor leaving the liability for violations of Russian law to the latter does not free the foreign company from liability in the eyes of the clients in the Western markets.<sup>44</sup> This is a good example of the weakness of legal centralism. A company, which has not violated legal rules and is not legally responsible for its cooperation partners may more effectively be sanctioned by losing its reputation in the eyes of its client than in the courts.

Sometimes the trust in a reliable Russian partner may be dangerously strong. In the interview study of wood importing companies in Finland a representative of one small Finnish company stated that a Russian lawyer writes their contracts in Russian on behalf of their Russian business partner. The small company did not even bother to invest in translating the contracts into Finnish or English, because it was costly and they simply chose to rely on their business partner. The manager was of the opinion that formal requirements were requirements of Russian legislation and a Russian lawyer knows how to deal with them. Such an opinion indicates that Finnish businessmen also saw that the informal part of the deal is

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<sup>44</sup> Nysten-Haarala, Soili (2006) Contract Law and Everyday Contracting. In Peter Wahlgren (ed.) Scandinavian Studies in Law. A Proactive Approach. Stockholm Institute for Scandinavian Law, Vol. 49. Stockholm, 263-283.

what counts between business partners, not the formal document.<sup>45</sup> The attitude of this particular businessman may also indicate a mixture of understanding Russian informal rules and Nordic small business culture, where a handshake is enough. You simply have to take risks in business.

### *3.3. Requirements concerning the Form of the Contract*

The need to write formal contracts in the Russian rigid and official way seems to be an unexpected finding even for international businessmen, who have worked globally and have experience in many different contract and business cultures:

Most agreements in America are sealed with a handshake. In Russia, people are very rigid and the business climate is very strict: even the main points about the contract that were discussed during the meeting need to be noted in the protocol and signed by all participants of the meeting. I have never done anything like this in any of the countries I have worked, neither in Brazil, the United States, nor in India. That is a big difference. (manager\_USA).

Formal contracts need to be very detailed and all the changes also have to be in a written form because of the tight government control. Discounts, which are given afterwards, may confuse tax officials, who require proof of any change, which may affect on the taxed amount of profit. Although only a few contracts end up in courts, the practice of *arbitrazh* courts of not accepting oral contracts strengthens the formal practices of business contracting.<sup>46</sup> The courts simply interpret the Civil Code, which gives the written form as a formal requirement, although other materials can be used in interpreting the content of the contract in court. Even after the recent changes in civil law, oral proof is not necessarily accepted in Russian courts.

I: What is the level of detail with regard to the requirements that each side needs to fulfill in the contract?

R: Very detailed, up to ... any discount is prescribed in a supplemental agreement, that is, there are clients who have some special arrangements with us, they receive benefits and so on. For each bill we have a supplementary agreement, some people have piles of such

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<sup>45</sup> *Op. cit.*

<sup>46</sup> Hendley, Kathryn (2001) Beyond the Tip of the Iceberg. In Peter Murrell (ed.) Assessing the Value of Law in Transition Economics. Ann Arbor, Michigan University Press, 20-55.

contracts. The contract itself is very basic – everything is written down: the terms of payment, the terms of granting power of attorney to an employee who arrives for a bill of lading, everything. (manager\_Germ)

### *3.4. Changes in Circumstances*

Rigid contracts are, however, not necessarily complied with. Business partners may agree to make changes or implement the contract differently from the formal document. The study on wood importing companies revealed that Finnish companies valued continuing cooperation and were ready to adjust to changed circumstances. However, if the partner turned out to be unreliable, they simply found a new business partner and dropped the old partner out when their fixed-term contract for one year ended.<sup>47</sup>

There is also systemic negligence in implementing contracts. Contract regulations are regularly violated, but this rarely leads to any sanctions. Some managers stated that delayed payments for services are a frequent nuisance. Timely payment is even exceptional and delaying payments some kind of customary practice of the market:

I: To what extent do contract parties honor the agreements? That someone didn't do something on time or didn't pay, does that happen?

R: In general, it is difficult to control it, because we have too much clients. We can't ... I mean, we see, that there is an unpaid bill. The accountants already noticed it, they call and ask – why don't you pay? But, as a rule, there are a lot of clients that don't pay until the last moment. And the only way to get money from them – is when they are ordering the next container, we first look at their debts. Until our financial department allows us to process the order, our import department doesn't issue the necessary documents to our clients. First of all we look at the clients' debts and tell them – you have unpaid bills. They immediately start whining – how could it be? Please, give us a container and so on. They try to use all possible tricks....In general, anything they can come up with. And we look at debts – no, you have an unpaid bill. But we can only do that before sending another shipment. If we have already sent them a container, it is very difficult to do it post-factum. Because we have a lot of other stuff to do – we can't trace everything. That's why, actually, the payment period of five days is rarely observed. (manager\_Germ).

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<sup>47</sup> (Nysten-Haarala 2006)

According to Kathryn Hendley since 1993 at least 40 percent of the contractual disputes in *arbitrazh* courts have involved non-payments.<sup>48</sup> She describes non-payment as almost epidemic.<sup>49</sup> Our more recent study proves that non-payment is still a practice in Russian business. A search from the database of Russian *arbitrazh* court concerning years 2011-2012 reveals that the three companies, which we interviewed have sometimes also resorted to courts in order to get their payments. All cases, which they were involved in, concerned claiming for payments.

According to Kathryn Hendley the practice started with the reforms of 1990s, when the whole economy suffered from non-payment: salaries were not paid, the government did not have money and the privatized business was to a great extent near bankruptcy.<sup>50</sup> Non-payment up till the last possible moment must have been a practice also earlier, since prepayment was an established practice in foreign trade during the Soviet Union. According to interviews in 2004 prepayment was still an ordinary contractual clause in sales contracts with Russian partners. The Finnish wood buyers, however, did not all apply prepayment, but explained that banks function quite normally and that the price can be paid safely on a Russian bank account of the seller. Based on the interviews of Russian sellers of wood, Finnish buyers were very popular, because they were reliable.<sup>51</sup>

Obviously paying on time was an advantage on a market, where not paying or paying as late as possible is epidemic. Prepayment could have encouraged delivering lower quality, since quality control was the weak part of wood trade. Wood buyers, however, had the advantage of long-term relations, which allows corrections of quality, quantity or price with the next lot. This, however, is a bit complicated, because all adjustments of contract had to be written for the sake of customs and tax control.

The practice of not paying can be interpreted to indicate low respect of formal rules of the game and a “who cares”- mentality. Claiming invalidity of the contract in court as a counter claim to the claim for payment of the seller gives an impression that non-payment is not even

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<sup>48</sup> Hendley, Kathryn (1998) Temporal and Regional Patterns of Commercial Litigation in Post-Soviet Russia. *Post-Soviet Geography and Economics* 39 (7), 379-98.

<sup>49</sup> Hendley (2001).

<sup>50</sup> *Op. cit*

<sup>51</sup> (Nysten-Haarala 2006)



regarded as a loss of reputation and that all methods can be used no matter how absurd it may seem. In other words, non-payment is not exceptional and far from being shameful.

The practice of not paying before the last minute may on the other hand simply represent a business adjustment of the market. If paying on time is not effective in the circumstances of Russian markets, avoiding paying as long as possible will become the rule of the game.

#### 4. The Role of lawyers and courts in Russian business

The profession of a lawyer, let alone a company lawyer, was not highly appreciated in the Soviet Union. The work was quite administrative, consisting of writing claims (*pretenziia*)<sup>52</sup> and checking that contracts correspond with the formal legal and administrative rules. Nowadays the profession is more highly valued. The work of a company lawyer is still quite simple. Contracting remains quite rigid and formal, and the lawyer is there to check that all the rules and numerous regulations are fulfilled and that the contract will be legally binding. Company lawyers also take care of court cases. Simple non-payment cases are not legally challenging. Company lawyers also claim that disputes with tax officials are easy, because the tax officials are unprofessional and the Tax Code favors tax payers with allocating the burden of proof strictly on the tax officials (Article 22 of the Tax Code).

The amount of invalidity claims as counterclaims towards non-payment claims indicates that the court procedure is played strictly with the rules of lawyers without taking business needs into consideration. Disputes, as soon as they have entered courts, are totally out of the hands of businesspeople. Reputation in business does not seem to count any more. Hopefully the recent reforms of the civil code will diminish artificial claims for invalidity.

Furthermore, Russian business tends to turn to the courts quite often. The fear of losing reputation or showing a failure with ending up in court does not seem to be nearly as high as it is in the western countries. Russian courts are also much better than their reputation. Ordinary people suspect that courts and judges are corrupted or arbitrary, but this probably

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<sup>52</sup>*Pretenziia* is a claim for a company, which has not paid, or has delivered lower quality than agreed to deliver correct quality or pay damages. Without a *pretenziia*, the court would refuse to take the case.

only reflects the general tendency of corrupted practices and the constant complain about them in Russian society. Courts and *arbitrazh* judges, however, enjoy about similar level of respect both among the general public and businesspeople than their counterparts in Great Britain.<sup>53</sup> Respect for courts and ethical standards of the judges are actually much higher than for any other institution in Russia.<sup>54</sup>

In surveys foreign businessmen express great wariness toward the impartiality of Russian courts. They fear that courts would favor the Russian party to the dispute. The fear may simply indicate prejudice of foreign businessmen, because statistically there is no evidence of partiality of Russian courts. On the contrary, Glenn P. Hendrix reports on good experience of Western lawyers who have litigated in Russian *arbitrazh* courts. He, however, reminds that lawyers may have a need to exaggerate the effect of court proceedings to outsiders.<sup>55</sup>

Private commercial arbitration is not as much applied in Russia as in the western countries. The reason may be that it is a new institution, which has not developed yet. Disputes of foreign trade were taken before the Chamber of Commerce and Industry of the RF (earlier USSR) in the Soviet period, but there was no practice of domestic arbitration. Company lawyers claim that disputes take a longer time in private arbitration because “*the arbitrators do not work full time in arbitration and because their professional quality is not necessarily high*”. Ordinary *arbitrazh* courts are preferred instead of commercial arbitration because of the speed and quality of the work. Legislation on commercial arbitration, which was issued in 2002, provides with rules for similar private commercial arbitration than in western countries. It is, however, possible that Russian business complains easily on awards, which are not decided on their own favor. *Ordre public* may be more easily discovered, and since arbitration is new, there may be more mistakes.

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<sup>53</sup> The percentage of the general public relying on the legal system either a great deal or quite a lot was 38 % in Russia and 68 % in Great Britain. The figure for purchasing managers is 34,9 % in Russia and 35 % in Great Britain (World Values Study Group in 1991 reported by Hendley, Kathryn, Peter Murrell and Randi Ryterman (2001) *Law Works in Russia: The Role of Law in Inter enterprise transactions*. In Peter Murrell (ed.) *Assessing the Value of Law in Transition Economics*. Ann Arbor, Michigan University Press, 56-93, (p. 60).

<sup>54</sup> Hendley & al. 2001.

<sup>55</sup> Hendrix, Glenn P. (2001) *Foreign Litigants in Russian Commercial Courts*. In Peter Murrell (ed.) *Assessing the Value of Law in Transition Economics*. Ann Arbor, Michigan University Press, 94-132.

Alternative dispute resolution such as mediation is not wide spread in Russia. There is, however, a law on ADR from 2010, which means that mediation is encouraged and can in course of time increase as well as arbitration and other means of alternative dispute resolution. In Russia it is very important that subsequent legislation exists. Otherwise the institution is non-existent and avoided. Regulation, however, can lead to too rigid and clumsy practices for the sake of state control.

Bilateral means of negotiations, however, are widely used and business partners actively use informal methods for solving problems in the contractual relationship. The world of informal rules is, however, not always a simple one, since it is hidden and closely interactive with the rigid formal rules. Application of informal rules has to be learned in practice and often through making mistakes. The weakness of formal rules and the strength of often hidden informal rules make Russia a challenging market for foreigners.

## 5. Conclusions

A sharp distinction between formal legal rules and informal business rules is typical in Russia. The strong legal centralist approach of lawyers means they do not care for such disparities, but focus only on legally relevant problems. As in western countries, lawyers specialize only on law without paying too much attention to business rules and practices. Lawyers are there to check the legality of rigid documents and take care of disputes in courts. The gap between law and business is even wider in Russia than in the western countries, although the legal centralist attitude in principle is the same.

The special feature in Russia is that rigidity of rules and the existence of excessive and arbitrary control leads to avoidance and circumvention of formal rules, which are regarded as strange and unnecessary. When formal rules are not respected, they are more easily neglected. The formal legal default rules themselves do not greatly differ from their counterparts in western countries, although Russian text books make a distinction between domestic and international contract law. The emphasis on formal requirements is a remnant of the soviet past and a sign of a legal centralist attitude, which exaggerates the power of legal rules. The lower status of trade usages and business practices can also be interpreted to

indicate strong legal centralism and as need to control contractual relations in spite of the newly born freedom of contract. Recent changes of the civil code have, however, diminished formal requirements.

The tendency to misuse legal rules, which were created in order to protect business, sometimes leads to absurdities. Loopholes are constantly amended, but that does not prevent creative misuse of law. Flexibility is often creative circumvention of formal rules, which creates inefficiency in business. Content capabilities of Russian lawyers seem to cover only knowing the formal rules and requirements of law. Such an attitude makes lawyers focus on lawyering tricks instead of drafting proactive contracts, which serve business in the long run.

Not only law, but also business practice often appears to be rigid. The reason for this rigidity is the requirements of the bureaucratic administration. Formal contract documents are made neither for business purposes nor for potential court disputes, but to cope with the rigid administrative control of state authorities. There are certainly informal ways to circumvent the rigid control, but foreign businesses are more vulnerable than domestic business for claims of illegal practices on the part of authorities. Formal and rigid rules as well as their arbitrary applications, seem to lead to circumventing and ignoring them as well as to low respect of authorities. While in western societies the role of authorities is considered to be creating a favorable framework for business to operate, in Russia it obviously seems to be controlling businesspeople from resorting to illegal practices. Excessive control of authorities, however, makes business vulnerable for bribery and other means to speed the work of authorities.

Rigid business practices because of the scrutiny by authorities reflect only the surface of Russian rules of the game in business contracting. Under the surface, informal practices can be flexible. The surface can be broken only by creating trust and managing to maintain it with the business partners. Hidden practices may not be rigid and complicated once they are discovered and properly understood. Flexibility has to be created based on personal relations and trust. Relational capabilities of contracting are the more valued, the more formal rules are rigid. Local informal rules are an important part of the Russian plurality of norms. Ignoring them is going to lead to inefficiency and constant struggles with formal rules and control of the authorities.

The strength of informal rules may also keep Russia separated from international practices. Russia does not seem to bend to international (American) practices of contract drafting, but keeps to its own. There is a certain barrier for international business constituted by the rigid formal rules, which require excessive transaction costs and by the hidden informal rules, which require effort and costs to attain familiarity. The distinction between domestic and international contract law also leads to specialized lawyers of international trade and international arbitration.

Although the multiplicity of norms is visible in Russia, the effect of globalization in contracting practices seems to be rather limited. The reason, however, is not a strong nation state with strong formal rules, but on the contrary, weak formal rules and strong informal practices, which have developed in order to enable business survive in the world of strict formal rules.

Courts are not as bad as they are claimed to be - at least compared to their western counterparts. The Russian federation has actually invested a lot in courts, which are regarded as the engines of the rule of law. Court practice, however, has preserved administrative practices from the soviet times. These practices require excessive use of courts in such issues as non-payment. In the western countries courts are not regarded as creators of rules for the business, but as the last resort when something goes wrong. In Russia courts seem to be one available alternative among others to solve disputes. Court procedure seem not be avoided as eagerly as in the Western countries. Maybe courts are also used a lot, simply because court decisions are needed for enforcement even in clear non-payment cases.

Flexibility in Russia can be practical agreeing and setting rigid formal rules aside when they are too complicated to apply. In this way flexibility saves excessive transaction cost. Flexibility can, however, also be unwanted, when informal rules require a lot of transaction costs to get familiarized with. Flexible contracting culture is on the one hand a necessity when contract law is too rigid. On the other hand it can develop traps for even experienced businessmen.

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**Achieving flexibility in contracting by using vague terms  
in international business contracts:  
A comparative approach from the perspective of  
Common law, German, Polish and Chinese Law**

JOANNA GRZYBEK,<sup>1</sup> TINA DE VRIES,<sup>2</sup> YANAN ZHANG<sup>3</sup>

It is common to find general clauses referring to codes of ethics, professional standards and customs in commercial contracts between parties from different legal systems. Those clauses may impose obligations or provide permission to apply certain provisions, rules or customs. Such general clauses may contain vague phrases, such as ‘principles of fair trading’, ‘good manners’, ‘common good’, ‘important reasons’, ‘legitimate reasons’, ‘special circumstances’, ‘good faith’, “friendly negotiation”. The examples are taken from different legal texts such as statutes and contracts written in Chinese, German, Polish and English. The vague contract terms are taken from standard contracts that are used in certain fields of commerce in which long-term obligations are usually found, for example, construction contracts.

What do those general clauses and vague phrases in contracts mean to commercial parties? Do they really have the same understanding when they sign the contracts? Can such clauses and phrases be understood flexibly to accommodate both parties’ commercial interests? How important are such clauses for those parties who seek long-term relationship?

The authors show the differences in the meaning of selected general clauses, which apparently signify the same entities and concepts but in fact differ significantly due to the different law-systems that form the background of those terms and other factors. The main aim of this Chapter is to establish the constituent characteristics of the concepts being analyzed and to distinguish near equivalence and partial equivalence of selected vague phrases referring to codes of ethics, professional standards and customs.

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<sup>1</sup> PhD, Institute of Linguistics, Adam Mickiewicz University, Poznań, [joanna.grzybek\(at\)gmail.com](mailto:joanna.grzybek(at)gmail.com)

<sup>2</sup> Senior research fellow with responsibility for Polish Law, IOR Munich, [tina.devries\(at\)ostrecht.de](mailto:tina.devries(at)ostrecht.de).

<sup>3</sup> PhD, Lecturer and researcher, International Law School, Shanghai University of Political Science and Law, Shanghai, P.R. China, [yanan2\(at\)hotmail.com](mailto:yanan2(at)hotmail.com) or [yananzhang6\(at\)163.com](mailto:yananzhang6(at)163.com)

## 1. Introduction

Contracting is a process that culminates in the finalizing phase in which the contract is actually signed and then executed. The process of contracting starts with developing trust in the future contract partner, followed by a phase in which the parties negotiate the terms of the contract and finally the matter is closed in a contract. Therefore one might seek flexibility in contracting in the first two stages of the process of getting to contract rather than in the later period after the signing of the contract. A contract, once concluded, binds the parties and is intended to remain binding even if circumstances change. For instance, if the financial position of one of the parties changes, his or her need for the object of the contract alters or the value of the object goes up or down, the validity of the contract itself will not be affected.<sup>4</sup> The principle of *pacta sunt servanda* is guaranteed in most, if not all legal systems respecting individual liberties and the freedom of contract.<sup>5</sup>

But even if the contract is fixed and closed, a need may arise to adapt the contract to altered circumstances. This need may be most acute in contracts entailing continuous obligations for a significant period.

One can argue that trust and negotiation never entirely cease during the process of getting to a contract. Trust as an inherent and accompanying value must be established and maintained. In the contract itself it is often expressed as the principle of “good faith” that lies underneath the provisions of the contract and it is of course also expressed in the private law rules of the different legal systems.

## 2. How does vagueness foster flexibility in contracts

Flexibility for the period after the rendering into force of the contract can be achieved by several methods.

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<sup>4</sup> Hondius, E., Grigoleit, H.C., (2011), ed., *unexpected circumstances in European contract law*, Cambridge: University Press, p. 3.

<sup>5</sup> *Ibidem*, p.4.

Frame contracts are used for the purpose of designing a frame for the general conditions in, for instance, a long term delivery relationship. In contrast, the concrete price, time and amount of a special delivery is fixed by additional single contracts for each sale.

There are boilerplate-clauses that indicate a duty to negotiate certain matters, if a specific need to do so arises. This formalizes the principle that communication never entirely ceases even after the enforcement of a contract. These clauses can be taken from template clauses, i.e. the Principles of European Contract Law (PECL) which can serve as a model for a contract when the parties have agreed to incorporate them into their contract. Hardship-clauses or force-majeur-clauses often state the duty to renegotiate terms in case the performance of a contract becomes more onerous to the parties. Art 6:111 PECL contains a duty to negotiate, if circumstances change. Other legal rules which can likewise be used as templates contain similar but not identical obligations to negotiate when certain conditions are met.<sup>6</sup> The INCOTERMS for example contain a secondary obligation about who has to inform the other partner about what. Another common method to make a contract more flexible is to use vague terms in it, so that the contract would fit under a variety of circumstances. There are contract clauses referring to codes of ethics, professional standards and customs which are applicable to the relation regulated of the contract. Clauses containing vague phrases are often also used in flexible contracting between parties from different legal systems to impose obligation or permission to apply certain provisions, rules or customs such as: “good faith”, “reasonableness”, “onerous”, “due progress”.

In this article we would examine the selected vague phrases/clauses of good faith and reasonableness from contracts actually used in business transactions, business template contracts or other legal instruments and would try to show how they would be understood (although the text is the same) under common law, German, Polish, and Chinese law.

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<sup>6</sup> Ibidem, p. 657.

### 3. The concept and scope of the term “general clause”

It is not easy to define precisely the term “general clauses” in Polish literature and legal acts for example there are numerous discrepancies and diverging functions or definitions for vague clauses or phrases.

In accordance with s. 155 lit. 1 of the annex of the decree of the President of the Council of Ministers from 20.6. 2002 on the Rules of Legislative Techniques<sup>7</sup> the legislator may apply terms with flexible meanings, general clauses or indicate uncrossable upper and lower borders of freedom of decisions, if there is a need to provide flexibility of a statutory instrument<sup>8</sup>.

General clauses in the language of the law are usually understood as:

- specific legal provisions containing various types of terms with flexible/undefined meaning<sup>9</sup>
- terms with flexible/undefined meaning out of which the content of legal provisions is composed.<sup>10</sup>

As far as the application of general clauses is concerned in Polish legal literature scholars favor the institution of “reference”. It means that the text recipient is referred to general assessment criteria of non-legal character – that is to say moral values, political values or economic values.<sup>11</sup> This stance finds confirmation in the following definition: “a general clause is a flexible expression included in a legal provision referring to certain assessments typical of a given social group, to which such a legal provision refers by obliging persons to abide by them when determining a factual state of affairs regulated by a given norm”.<sup>12</sup>

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<sup>7</sup> Załącznik do rozporządzenia Prezesa Rady Ministrów z dn. 20 czerwca 2002 r. w sprawie "Zasad techniki prawodawczej", Dz.U. no. 100, pos. 908.

<sup>8</sup> „Jeżeli zachodzi potrzeba zapewnienia elastyczności tekstu aktu normatywnego, można posłużyć się określeniami nieostrymi, klauzulami generalnymi albo wyznaczyć nieprzekraczalne dolne lub górne granice swobody rozstrzygnięcia”.

<sup>9</sup> Wolter, A., Ignatowicz, J., Stefaniuk, K. (1996) *Prawo cywilne. Zarys części ogólnej*, Warszawa: Wydawnictwa Prawnicze PWN, p. 67.

<sup>10</sup> Zieliński, T. (1988) *Klauzule generalne w prawie pracy*, Warszawa: Wydawnictwo Prawnicze, p. 38.

<sup>11</sup> Rott-Pietrzyk, E. (2007) *Klauzula generalna rozsądku w prawie prywatnym*. C.H. Beck, Warszawa, p. 280-281.

<sup>12</sup> Radwański, Z., 2003, *Prawo cywilne – część ogólna*, C.H. Beck, Warszawa, 51.

Therefore a general clause is understood as a type of authorization for a body applying the law to use the criteria specified in a given general clause in the decision-making process.

There is, however, another stance in accordance with which general clauses are obligations of government bodies applying the law to assess factual states of affairs on their own. Such assessments shall be made in reference to all circumstances and earlier decided cases. The rules, principles, norms and moral values specified in a general clause are treated as a factor which is either a starting point or a guide in the process of making judgments by law-applying bodies.<sup>13</sup> According to *W. Wolter*, the legislator consciously does not (or may not) want to state more precisely the meaning but designates only some more or less subjectively specified meaning “field” which is to be filled in by the court practice with its individual assessments and judgments.<sup>14</sup>

Both notions about the aim of general clauses are reasonable and reflect a certain function of general clauses. The second stance presented in the doctrine and the cited decree of the Polish President of the Council of Ministers would suggest the application of general clauses for achieving flexibility in lawmaking and contracting. It is clear that flexibility in contracting may be preserved by applying general clauses instead of precise guidelines. Such clauses could refer to general rules, i.e. principles that are laid down in a law of a higher rank such as the constitution, to principles of social behaviour and conduct, to ethics customs etc. Especially in the case of contracts whose parties come from different legal systems expressions with flexible meaning may enable flexibility in interpreting contract fragments in which they are used.

#### 4. General Clauses in international business contracts

There are several legal instruments – some of them stated before – which can serve as a model for the contract, as a template.

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<sup>13</sup> Rott-Pietrzyk, 2007, see supra note 11, p. 282-283.

<sup>14</sup> Wolter, W, 1976, *Uwagi o znamionach wymagających ilościowej oceny*, in: Państwo i prawo, vol. 6., p. 25.

#### 4.1. Instruments issued by private organizations

Instruments issued by private organizations which contain international rules for the interpretation of standard contract formulas are for example the INCOTERMS from the international chamber of commerce. Template contracts for certain fields of contracting include, for example, the ORGALIME General Conditions that are primarily intended for use in international contracts for delivery of engineering industry products in general, or the FIDIC rules which contain guides and templates for international contracts and business practice documents. Although they are referred to as “*lex mercatoria*” it is now the common opinion of scholars that they are not totally independent from the national law system from which they were originally drafted,<sup>15</sup> so i.e. the FIDIC rules – although the full name of FIDIC: “*Fédération Internationale des Ingénieurs-Conseils*” – implies French roots were drafted from a common law background.<sup>16</sup>

#### 4.2. Instruments issued by international organizations, branch associations or academic groups

There are also legal instruments that can serve as contract templates of a more general scope, issued by international organizations, branch associations or academic groups. Such are the UNIDROIT principles of international commercial contracts (UPICC), the principles of European contract law (PECL) or the Draft Common Frame of Reference (DCFR) as a restatement of principles of general contract law.<sup>17</sup> All of these documents contain also general clauses.

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<sup>15</sup> Lorenz, M., 1993, *Unterbeteiligungen an Krediten im Common Law und im Civil Law*, in: *Untersuchungen über das Spar-, Giro- und Kreditwesen* Bd. 84, Duncker und Humblot, Berlin, p.358.

<sup>16</sup> Triebel, V., Balthasar, S., 2004, *Auslegung englischer Vertragstexte unter deutschem Vertragsstatut, Fallstricke des Art. 32 I Nr. 1 EGBGB*, NJW, 2189, p.2191.

<sup>17</sup> Cordero-Moss, G , 2011, *Does the use of common law contract models give rise to a tacit choice of law or to a harmonized, transnational interpretation?* In Cordero-Moss, G. (ed.) *Boilerplate Clauses in International Commercial Contracts and the applicable law*, Cambridge University Press, p. 37-61, p.44.

#### *4.3. Typical examples for vague clauses in international template contracts*

The PECL for example contain the vague clauses of good faith, fair dealing, certainty (in contractual relationship) and uniformity (of application) and also reasonableness in several articles. The term reasonableness is used as often as 75-times in the PECL and was also defined there in Art. 1:302 :<sup>18</sup>

##### Article 1:302: Reasonableness

Under these Principles reasonableness is to be judged by what persons acting in good faith and in the same situation as the parties would consider to be reasonable. In particular, in assessing what is reasonable the nature and purpose of the contract, the circumstances of the case, and the usages and practices of the trades or professions involved should be taken into account.

The DCFR also contains vague clauses of “good faith”, “fair dealing” and “legal certainty” as well as “reasonableness” in the field of interpretation and development of a contract concluded under those rules. An overlook of typical boilerplate clauses shows that vague terms are frequently used in those clauses as given by Cordero-Moss.<sup>19</sup> I.e. the typical hardship clause relates to an “event that was beyond a party’s reasonable control and was one which it could not reasonably have been expected to have taken into account at the time of the conclusion of the contract and that the event and the consequences could not reasonably be avoided or overcome”.<sup>20</sup>

#### *4.4. Concrete clauses taken from a FIDIC based Contract*

The vague term of reasonableness is also used in the FIDIC template about the delivery of technical goods and their long term maintenance. Reasonableness is mentioned in what can be seen as a typical clause for risk distribution between the contractor and the owner. This clause reads:

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<sup>18</sup> Rott-Pietrzyk, E. (2005) *Pojęcie rozsądku w projekcie Europejskiego Kodeksu Cywilnego*, in Ogięły, L., Popiołka, W. Szpunar, M. (ed.) *Rozprawy prawnicze, księga pamiątkowa profesora Maksymiliana Pazdana*, Kantor Wydawniczy Zakamyczy, p. 701-719.

<sup>19</sup> Cordero-Moss, G , 2011, *Introduction to part III*, in: Cordero-Moss, G. (ed.) *Boilerplate Clauses in International Commercial Contracts and the applicable law*, Cambridge University Press, p. 119.

<sup>20</sup> *Ibidem*, p.122.



If and to the extent that any of those risks (specified risks defined to be in the sphere of the owner) above results in loss or damage to the works, Goods, (as the case may be), the Contractor shall (i) without undue delay give notice to the Owner and (ii) rectify this loss or damage to the extent that the rectification is possible by **commercially reasonable means** and instructed by the Owner.

And also in the following clause:

If the Contractor suffers delay and/or incurs Cost as a result of rectifying loss or damage which was instructed by the Owner to be rectified or otherwise as a result of the occurrence of any of the matters listed above the Contractor shall give a further notice thereof to the Owner and shall be entitled to:

- (a) an extension of time for any such delay; and
- (b) payment of any such Cost, which shall be added to the Contract Price. In the case of sub-paragraphs (b), (c) and (d) above, the Contractor shall be entitled **to any such Cost plus reasonable profit.**

So in this clause reasonableness was placed in the context of commercially reasonable means and reasonable profit.

In this contract there is also a clause of commitment to amendment which provides flexibility in the contract and is interesting because more and more projects are financed by banks or financial institutions and the banks do often take a seat in the negotiations.

This clause reads:

The Parties acknowledge, and the Contractor agrees, that the Owner will partially finance the payments due under this Contract by means of the Financing that will be granted to him by the Financial Institutions. Consequently, and considering the need for the Owner to obtain the Financing in order to pay the entire Contract Price, **the Parties agree to negotiate in good faith** and make every effort to amend those provisions of this Contract, the amendment of which is expressly requested by the Financial Institutions as a condition for obtaining the necessary financing for the implementation of the project.

Here the vague term “good faith” is related to the way the negotiations should be conducted.

Another clause that is frequently found in template contracts and also in our example contract is a clause about the principle of an overall application of good faith for the execution of the contract combined with a conflict resolution clause.

The Parties **undertake to fulfil this Contract in good faith, resolving through negotiations and mutual agreements any disputes which may arise between them** regarding its application, development, fulfilment, interpretation and implementation. In the event that an amicable settlement is not reached within ten (10) days from the beginning of the dispute that stated in the following paragraphs shall apply.

These clauses are taken from FIDIC-forms of contract. FIDIC-forms of contract are embedded in the common law notwithstanding the fact that some of its features may be influenced by civil law. In fact no specific endeavors and efforts have been made to emancipate FIDIC-forms of contracts of its basic roots, which are undeniably identified as being the common law.<sup>21</sup>

#### *4.5. The need for the translation of contracts and the need for awareness of different meanings in different languages and different legal contexts*

In concluding a contract one has to distinguish between the applicable law of the contract, the original language of the contract and (convenience) translations of the contract for a better understanding of the contract for interested persons.

An international business contract often contains a choice of law clause that may be formulated as follows: *“this contract shall be governed by (i.e.) Polish law.”*

The applicable law of the contract has normally an underlying language. The language reflects the way of legal thinking, and this way of legal thinking shapes the methods of legal regulation and control, whether in legislation, case law, or even in the form of a contract.<sup>22</sup> A contract has a law that is applicable to it. If for example the applicable law to a contract is the

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<sup>21</sup> Bunni, N.G., 2005, *FIDIC forms of contract*, 3<sup>rd</sup> ed. Blackwell, Oxford p. 10.

<sup>22</sup> Döser, W.H., 2000, *Anglo-amerikanische Vertragsstrukturen in deutschen Vertriebs-, Lizenz- und sonstigen Vertikalverträgen*, NJW, p. 1451-1455, p. 1451.

Polish law, then that law is written and effective in the Polish language as that is the official language of Poland.<sup>23</sup> Although the official language of the contract doesn't need to be Polish unless the contract is a contract involving consumers or public institutions or it is a contract in the field of labor law<sup>24</sup> the Polish law and therefore the understanding of several law institutions in the Polish language are crucial for the understanding of the contract.

The same can be said about the application of any other law system, except that it is probably an exception rather than a rule that there is a statute which expressively states the applicability of a certain language to a contract completed under a certain jurisdiction.

So if a contract is formulated in English but the German law applies there is a discrepancy between the English terminology of the contract and the German legal language. This may cause confusion to the interpretation of the contract as certain terms (such as the terms examined here: "good faith / Treu und Glauben" or "reasonableness") are embedded in a certain legal surrounding that has to be mediated into different national legal spheres.

Things get even more complicated, if a contract is drafted after a common law template in English and the German law applies, either by explicit choice of German law made in the contract or because German law as the applicable law could not have been effectively excluded in certain areas of the contract provisions.<sup>25</sup> If such a contract is then dealt by a German court, the court would see the English style clauses in contracts governed by German law as a matter of contractual interpretation and therefore may use the English law as a tool to understand these clauses.<sup>26</sup> If typical English clauses and legal terms are used despite of the German applicable law, the English understanding of these terms may become relevant.<sup>27</sup> This approach is the prevailing opinion of higher courts in Germany. But German courts would tend not to use the English law for interpreting these clauses, if all other connecting

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<sup>23</sup> Art. 4 ustawa z dnia 7 października 1999 r. o języku polskim, Dz. U. 1999, no. 90, pos. 999; with later amendments.

<sup>24</sup> Art. 7 of the law of the Polish language, Ustawa o języku polskim, Dz.U.2011, Nr.43, Pos.224.

<sup>25</sup> More examples for language confusion are given in: Triebel, V., Balthasar, S., 2004, *Auslegung englischer Vertragstexte unter deutschem Vertragsstatut, Fallstricke des Art. 32 I Nr. 1 EGBGB*, NJW, p. 2190.

<sup>26</sup> Dannemann, G., *Common law-based contracts under German law*, in: Cordero-Moss, (ed.) *Boilerplate Clauses in International Commercial Contracts and the applicable law*, Cambridge University Press, p. 762-79, p. 78.

<sup>27</sup> Triebel and Balthasar, see supra note 16, p. 2193.

points of the case are German.<sup>28</sup> Even if the English text of the contract is taken from the background of the U.S. law, German courts would rather apply English law.<sup>29</sup> Vice versa the same principle doesn't apply. An English court would not judge a German contract to which the English law is applicable along with German interpretation guidelines<sup>30</sup> and also in the practice of international arbitration courts the clauses are rather interpreted neutrally along with their integral meaning.<sup>31</sup>

Even if the contract would be in English modeled along with English common law and the applicable law would be English common law, it is possible that a foreign judge decides the case. Certainly one may argue that these are rare cases, because if a contract contains a choice of law clause this is followed regularly by a choice of (secondary) jurisdiction clause, but still such cases occur. In these cases a German judge would have to apply the foreign law using the German language. Despite the progress in applying foreign law under the mediation of experts (§§ 293 ff ZPO) the basic legal understanding of the judge and his way of thinking determines the effect of a foreign law on his decision.<sup>32</sup>

Even if the translation of the contract is only for convenience, contractual provisions might be misunderstood by a contracting party who is not capable of fully understanding the original (legal) language of the contract. This may cause confusion regarding the concrete scope of contractual obligations to the persons who are responsible to execute the contract. To overcome these difficulties it is possible to implement a contract clause that refers to the meaning of the language. The following clauses are given as:<sup>33</sup>

**1. Interpretation of a contract written only in English in accordance with German law**

This agreement and its terms shall be governed by and construed in accordance with the laws of Germany. If the English legal meaning differs from the German legal meaning of this agreement and its terms, the German meaning shall prevail.

**2. Bilingual text, English text serves only for information**

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<sup>28</sup> Dannemann, see supra note 26 p. 78; an overview of the Court decisions is available in: Triebel and Balthasar, see supra note 16, p. 2193.

<sup>29</sup> Walz, S., *Beck'sches Fb Zivil-, Wirtschafts- und Unternehmensrecht, D-E*, C. H. Beck, München., 2010, Klauseln zum Verhältnis deutschen und englischen Textes – Clauses on the relation of German and English text, annotation no 1.

<sup>30</sup> For further reference see: Triebel and Balthasar, 2010, p. 2193, supra note 16.

<sup>31</sup> Triebel and Balthasar, 2010, supra note 16, p. 2193.

<sup>32</sup> Döser, 2000, supra note 22, p. 1451.

<sup>33</sup> Examples: Walz, 2010, see supra note 29.

This text shall be governed by and construed in accordance with the laws of Germany. The English version of this text serves only for information and is not part of this legal transaction. Therefore, in the event of any inconsistency between the German and the English version, only the German version shall apply.

**3. Bilingual text, German text prevails in case of doubt**

This text shall be governed by and construed in accordance with the laws of Germany. It shall be executed in both the German and the English language. In the event of any inconsistency between the German and the English version the German version shall prevail.

The FIDIC-contract is written from the background of an approach and language that still reflects the common law, but presumably not English law alone.<sup>34</sup>

Probably in most cases FIDIC-forms of contract will be used in their original, English version, although translations do exist and FIDIC-terms of contract are often used in a Civil law context.<sup>35</sup> Despite any contradictions with the applicable law, which may exist and must be recognized as the case may be, the use of English does not mean that the parties will understand the terms and clauses as an English native speaker will do.<sup>36</sup> Instead at the outset some of the wording used by FIDIC will be either misleading or even not make sense. It is therefore critical to have prior knowledge of FIDIC's common law background in order to render it understandable to non native speakers.

Typical clauses in the FIDIC contract that have to be explained from their legal background are amongst others the term "reasonable" which we are going to discuss here or the expression "workmanlike manner". These terms are well-developed through common law case law but they are also completely unknown to civil law countries.<sup>37</sup>

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<sup>34</sup> Jaeger A.-V., Hök G.-S., 2010, *FIDIC-A Guide for Practitioners*, Springer-Verlag Berlin Heidelberg, 2010, p. 99.

<sup>35</sup> *ibidem*.

<sup>36</sup> *Ibidem*.

<sup>37</sup> *Ibidem*.

## 5. Vague terms relating to different law families

The laws of the world are systematized by scholars into different law families. We are going to discuss in our article mainly terms from civil law systems: German, Polish and – also to a certain extent relating to this law family – Chinese law. Yet for contrasting the argumentation and being aware that the English language – which is also the language of this article – is connected to a common law system, we would like to relate also to the common law family (English, U.S. law).

### 5.1. Common Law systems

Common law is the legal tradition, which evolved in England from the 11<sup>th</sup> Century onwards. This legal tradition is the basis of private law not only for England as its country of origin, but also for further States of the Commonwealth and de facto most important the US (except from Louisiana which was influenced by French law). The principles of common law appear for the most part in reported judgments, usually rendered by higher courts, in relation to specific fact situations arising in dispute, which courts have adjudicated. All in all common law rules seem to be more specific and detailed in comparison to civil law rules.<sup>38</sup>

Common law is dominated by focusing on each single case, so called ‘reasoning from case to case’. Generalizations or principles are only developed through deciding single cases which form precedents for the decision of other cases. The central role in common law is played by the judge, who thinks and decides historically, concretely, goes by facts and whose decisions are normally not taken along a dogmatic conceptual construct.<sup>39</sup>

A contract in the common law system is characterized through the fact that contract law is generally more concerned with certainty and expects parties to write their contracts around deficiencies in English law.<sup>40</sup> Therefore they attempt to combine all rules to an agreement.<sup>41</sup>

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<sup>38</sup> Lengeling, D., 2008, *Common law and civil law – differences, reciprocal influences and points of intersection*; Toronto/Siegen 2008, [pdf] available at <[http://www.consulegis.com/fileadmin/downloads/thomas\\_marx\\_08/DLengeling\\_paper.pdf](http://www.consulegis.com/fileadmin/downloads/thomas_marx_08/DLengeling_paper.pdf)> (accessed 9. 7. 2013), p. 8.

<sup>39</sup> Ibidem, p. 10.

<sup>40</sup> Dannemann, 2011, supra note 26, p. 65.

Contracts drafted under the US-law – as part of the common law – are famous for their vast amount of regulations.<sup>42</sup> Today international commercial contracts are, with only a few exceptions, drafted on the basis of common law models.<sup>43</sup> Still the PECL or the Draft Common Frame of Reference are grounded more on the civil law tradition as the majority of EU-member States belong to this tradition.

## 5.2. Civil Law systems

Civil law may be defined as a legal tradition which has its origin in Roman law, as codified in the *Corpus Juris Civilis* of Justinian, and as subsequently developed mainly in Continental Europe. The civil law legal tradition itself can be divided further into the Romanic laws, influenced by French law, and the Germanic family of laws, dominated by German jurisprudence.<sup>44</sup>

A civil law system indicates for the contracting practice that the need for discussion and documentation has been limited by the existence of a large body of statute law, regulating relationships and limiting the room for debate.<sup>45</sup>

A civil law system is a system in which regulation (by statutes and administrative acts) rather than litigation plays a stronger role in lawmaking and this influences also contracting.

As *Posner* puts it:<sup>46</sup>

Regulation and litigation tend to differ along four key dimensions:

- (1) regulation tends to use ex ante (preventive) means of control, litigation ex post (deterrent) means;
- (2) regulation tends to use rules, litigation standards;

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<sup>41</sup> *Ibidem*, p. 66.

<sup>42</sup> Döser, 2000, *supra* note 22, p. 1451.

<sup>43</sup> Cordero-Moss, introduction, *supra* note 19, p. 115.

<sup>44</sup> Lengeling 2008, *supra* note 38, p. 10.

<sup>45</sup> Cummings T., 2010, *Best Practices in commercial contracting*, Scandinavian Law, vol. 49, p. 134.

<sup>46</sup> Posner R.A., 2010, *Regulation (Agencies) versus Litigation (Courts): An Analytical Framework*; in: D.P. Kessler, (ed.) *Regulation vs. Litigation: Perspectives from Economics and Law, Conference held September 11-12, 2009*, University of Chicago Press, p. 11 - 26.

(3) regulation tends to use experts (or at least supposed experts) to design and implement rules, whereas litigation is dominated by generalists (judges, juries, trial lawyers), though experts provide input as witnesses; and

(4) regulation tends to use public enforcement mechanisms, whereas litigation more commonly uses private ones—private civil lawsuits, handled by private lawyers although the decision resolving the litigation is made by a judge (with or without a jury), who is a public official (the jurors are ad hoc public officials).

A feature of this - probably in Germany in the purest prevailing system - is the conviction that all possible legal constellations are abstract, sufficient and regulated by just one law. One would have merely to look into the Official Law Gazette to find for each case the prior regulated rule.<sup>47</sup> From this is deduced the principle that individual arrangements between the parties need to contain only the statutory basics for the *essentialia* of the case, but beyond this regulation, even if the wording of the contract leads to a different assumption, the contract can be completed by the statutory regulations which can be found for instance in s. 133 of the German civil code, s. 157 German civil code and s. 9 of the law on general terms and conditions (AGBG).<sup>48</sup>

Contracts concluded under German law (as an example for a civil law system) are “the better the shorter they are”, they are structured in a way that leads from general to specific and they are divided into sections with weighted logical subgroups.<sup>49</sup> The detailed provisions by this way will be located closest to the highest relevant superordinate topic/preamble and are formulated as abstractly as possible, so as to encompass all conceivable variations of the later following system levels.<sup>50</sup> An example for this – though not taken from a contract but from the civil code of Germany – would be the division i.e. of the first book of the civil code, which contains the general part of the code. The first division is about persons – a more general description, followed by the first title about natural persons which are consumers and entrepreneurs and then in the sections of this title there are regulated special questions concerning the beginning of legal capacity, residence, lack of full capacity etc.

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<sup>47</sup> Döser, 2000, supra note 22, p. 1541.

<sup>48</sup> Ibidem.

<sup>49</sup> Ibidem.

<sup>50</sup> Ibidem.



### 5.3. The Chinese law system

It is not an easy task to define the Chinese legal system, which has to be understood in a dynamic manner by considering its historical, political, social, economic and cultural conditions. Looking at the legal history of China, Imperial China actually established its legal system, which has existed for at least two thousand years. There was an intense debate between two main school of thoughts (Confucianism and legalism) concerning which a state should use to effect social control; eventually Confucianism prevailed (Chen, 2000).<sup>51</sup> At the turn of 20th century, China started its quest for modernisation and development, modern legal reforms, which was mainly processes of Westernisation, started by the Qing Dynasty and continued by the Nationalist Government. In 1949, the Communist party defeated the Nationalist party and established the People's Republic of China (PRC). Then China changed to a socialist system and started the process of establishing a socialist legal system. However, the Cultural Revolution (1966-1976) broke out and lasted for about ten years, which was considered a political and social disaster and undermined the nascent Chinese legal system. In 1978, the 2nd generation of leader Xiaoping Deng started to reestablish the legal system in China. Thus, in a way, it is probably fair to say that the principal development of the current Chinese legal system started since the late 1970s.

China has long labelled itself as “a social system of laws with Chinese Characteristics” (Information office of the State Council of PRC, 2011). The legal system of PRC generally has the civil law tradition, but also was influenced earlier by the Soviet Union and later by the common law tradition. It mainly has codified laws; 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 sources of law in China are wide, including the Constitution of PRC 1982, National People's Congress (NPC) statutory law and other legislative enactments, international treaties and so forth (Shen, 2009).<sup>52</sup> The laws issued by the NPC (China's national legislature) and the administrative regulations adopted by the State Council (China's cabinet) are important in China.

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<sup>51</sup> Chen, Albert H.Y. (2000) *Socialist Law, Civil Law, Common Law, and the Classification of Contemporary Chinese Law*. In Otto, Jan Michiel and Polak, Maurice V. and Chen, Jianfu and Li, Yuwen (Eds.): *Law-Making in the People's Republic of China*, The Hague, London, Boston: Kluwer Law International, 55 - 74.

<sup>52</sup> Shen, Zongling (2009) *Jurisprudence*, 3<sup>rd</sup> ed., Peking: Peking University Press, 263-270.

In order to integrate itself to the global rules-based trading system, China has made enormous efforts to adjust its legal system to Western Standards. China has undergone various economic reforms and legal reforms since its accession to WTO in 2001.

Legal concepts, terminology, institutions, and processes which have origin in Western countries can often be seen in Chinese laws. It is thus claimed that the development of Chinese law to a large extent is a process of legal transplantation (Chen, 2007).<sup>53</sup> However, certain external factors, such as environmental, social, economic, and cultural aspects can become barriers and have influence on the effect of legal transplantation (Kahn-Freund, 1974). But the term “legal adaptation” may be more proper to describe the phenomenon of legal reforms in China, as China usually firstly studies different models in other countries and international rules, learns ideas from them, and then adapts them to its own context. An American scholar considered Chinese legal reform as a process involving a filtering of those external influences for purpose of making the foreign elements compatible with Chinese legal and political culture (Head, 2009).<sup>54</sup> Some foreign scholars have recognized the weight that China’s past has; thus considered, the Chinese legal system seems like a western system but with the influence of its own traditions (Jones, 2003).<sup>55</sup> Some understand ‘Chinese law’ as a collective term emphasizing the plurality of legal systems (Menski, 2006).<sup>56</sup>

## 6. Problems of translating vague legal terms from a linguistic viewpoint

Legal translation theoreticians often carry out research into vagueness and fuzziness. They stress that numerous legal terms and expressions are used to refer to objects, institutions, relationships and procedures that are typical of a given legal system. *Each legal system has its own legal realia and thus its own conceptual system and even knowledge structure.*<sup>57</sup>

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<sup>53</sup> Chen, Jianfu (2007) *Modernization, Westernisation, and Globalisation: Legal Transplant in China*. Hong Kong Law Journal, (2007),37(II).

<sup>54</sup> Head, J. W. (2009) *China’s Legal Soul. The Modern Chinese Legal Identity in Historical Context*. Durham: Academic Press, 219-221.

<sup>55</sup> Jones, W. C. (2003) *Trying to Understand the Current Chinese Legal System*. In C. N. Hsu (ed.): *Understanding China’s Legal System. Essays in Honor of Jerome A. Cohen*. New York: New York University Press, 7-45.

<sup>56</sup> Menski, W. (2006) *Comparative law in a global context: The legal systems of Asia and Africa*. New York: Cambridge University Press, 3-4.

<sup>57</sup> Vanderlinden, 1995, *Comparer les droits*, Bruxelles, p. 328-337.

When talking about general clauses one shall not forget about the opinion of Šarčević (2000, p. 233) who claims that there are numerous indefinite or vague terms, such as ‘the best interests of the child’, ‘due care and attention’, and ‘good faith’, which are easily translated and already exist in most legal systems, but are interpreted differently by courts of different jurisdictions. So if they are interpreted differently, is it possible to apply general clauses at all in contracts between parties coming from different countries? It definitely requires vast knowledge going beyond legal one.

As far as translation is concerned Šarčević, opts for “measuring the degree of equivalence”. She claims that: Translators should be aware of the effects of differences of socio-political principles on interpretation. Some general clauses may have a political context and background, e.g. the Chinese syntagm “public needs/requirements” (公共利益的需要, *gōnggònglìyìdēxūyào*) should be interpreted in the light of the fact that in the Chinese People’s Republic land may not be owned by private individuals, and the arable land is only used by people who do not enjoy any legal protection against expropriation.<sup>58</sup> Those “public needs” enable the authorities to interpret legal provisions in various ways and may even constitute grounds for expropriation. So, as Cao investigating English-Chinese and Chinese-English translation, she correctly remarks: Linguistic uncertainty, whether it is ambiguity, generality or vagueness includes both intralingual uncertainty, that is uncertainty found within a language, and interlingual uncertainty, that is, uncertainty that arises when two languages are compared or when one language is translated into another language.<sup>59</sup> In such cases, words, phrases and sentences in one language may or may not be uncertain, but additional ambiguity or other uncertainty may arise when they are considered across two languages.

It should be stressed here that languages are indeterminate and the level of indeterminacy of different languages varies. Cao argues that the level of uncertainty of Chinese in comparison with English is higher. To support her thesis she refers to the opinion of *Grossfeld*, a jurist from German who considers the English legal language, ‘less concentrated’ or in other words ‘*more open-textured*’ than the German legal language. He also claims that legal concepts of the English legal system are vaguer which may pose subsequent problems.<sup>60</sup> Finally, *Cao*

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<sup>58</sup> Šarčević, S. (2000) *New Approach to Legal Translation*. The Hague: Kluwer Law, p. 233.

<sup>59</sup> Cao, D. (2008) *Translating Law*. Shanghai, Shanghai Foreign Language Education Press, p. 19.

<sup>60</sup> *Ibidem*, p. 80.

argues that in translation, new linguistic uncertainty, that is, interlingual uncertainty, may be created due to the differences in linguistic and legal systems. This sometimes is inevitable, not due to translators' mistakes, but because of the inherent nature of language. Often, the translator has to make hard decisions within the constraints of language.<sup>61</sup>

Another scholar dealing with legal language and legal translation *Tessuto*<sup>62</sup> claims that flexibility may be mostly found in syntagms<sup>63</sup> which constitute adjectival, adverbial and phrasal expressions. She also turns attention to the fact that a few terms are used to refer to such syntagms, namely the scholars write about vagueness, ambiguity, semantic indeterminacy,<sup>64</sup> or hedging.<sup>65</sup> Among such syntagms she enumerates the following ones: such as, as soon as practicable, award is appropriate, fair opportunity, the award shall be made promptly, necessary measures, as promptly as practicable, on proof satisfactory to it, good cause, good faith, reasonable costs, reasonable inquiry, any circumstance likely to give rise to justifiable doubt and adds that of these, it is telling that the abstract and broad concept of 'good faith' has become part of different legal discourses and genres in which they have no technical meaning or statutory definition either, whether or not in the US law.<sup>66</sup>

## 7. The interpretation and translation of the chosen vague terms of good faith and reasonableness under various jurisdictions

### 7.1. Common Law countries, especially England and USA

In literature on the English legal system it is stressed that there are no general clauses in the English law which would have a wide and universal scope of application--to all contractual

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<sup>61</sup> Ibidem, p. 81.

<sup>62</sup> Tessuto, Girolamo (2010) *US Commercial Arbitration Rules and Mediation Procedures: Linguistic and Discoursal Features of a Genre in Action*. in: Bhatia, V.K., Candlin, Ch.N., Gotti, M. (ed.) *The Discourses of Dispute Resolution*, Peter Lang, Bern, 2010, p. 259.

<sup>63</sup> Syntagms are combinations of two linguistics units resulting in what we understand as one word (Martinet, A. (1970) *Podstawy lingwistyki funkcjonalnej*, Warszawa, Państwowe Wydawnictwo Naukowe, p. 117-118).

<sup>64</sup> Bhatia, Vijay K., Engberg, Jan, Gotti, Maurizio, Heller, Dorothee (eds.) (2005) *Vagueness in Normative Texts*. Peter Lang, Bern, p. 12.

<sup>65</sup> Lakoff, G. 1973, *Hedges: A Study in Meaning Criteria and the Logic of Fuzzy Concepts*, *Journal of Philosophical Logic*, vol. 2; Channell, J., 1994, *Vague Language*, Oxford University Press; Hyland, K., 1998, *Hedging in Scientific Research Articles*. John Benjamins, Amsterdam.

<sup>66</sup> Tessuto (2010) see supra note 62, p. 259.

relations, for example--although the vague term “reasonableness” maybe the exception to this rule. General clauses have therefore a very limited scope of application in the English law. If a general clause appears in a given text it may be analyzed and interpreted only in reference to the statutory instrument in which it is used.<sup>67</sup> In American law, the restatement of the law of Contracts and the development of the Uniform Commercial Code in which the principle of good faith is stated as often as in over 50 code sections, the principle of “good faith” was given wider recognition.<sup>68</sup>

### 7.1.1. General rules for the interpretation of contracts

Under English law there is no canon of interpretation rules as is known under a civil law system -- as, for example in German law where the interpretation of contracts is applied as the wording, the grammatical sense, the systematic interpretation the teleological interpretation, etc.

Under English law the wording of the contract is crucial. As a starting point the meaning of the document is to be found in the document itself, so the Court tries to find the “ordinary and natural meaning” (Investors Compensation Scheme/West Bromwich Building Society<sup>69</sup>). This is because the courts do not easily accept that people have made linguistic mistakes, particularly in formal documents (Lord Hoffman in ICS, at 913). If the meaning of a contract stays unclear there are further rules of interpretation such as to reach the most commercial outcome (Rainy Sky SA and Others –v- Kookmin Bank [2011] UKSC 50). There are also rules about who should prevail, if ambiguity occurs in the contract such as the principle *in contra proferentem*.<sup>70</sup>

Still the wording of the contract is crucial in the interpretive process along with the parole-evidence-rule, in which verbal evidence is not allowed to be given ... “so as to add or

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<sup>67</sup> Rott-Pietrzyk, see supra note 11, p. 204-205.

<sup>68</sup> Farnsworth, E.A., 1995, *Duties of Good Faith and Fair Dealing under the unidroit principles, relevant international conventions and national laws*, Tulale Journal of international and comparative law, vol. 3, p. 47-63, p. 52.

<sup>69</sup> Investors Compensation Scheme v. West Bromwich Building Society [1997] UKHL 28; [1998] 1 All ER 98; [1998] 1 WLR 896 (19th June, 1997).

<sup>70</sup> Peel, 2011, *Boilerplate Clauses under English law*, in: Cordero-Moss, (ed.) *Boilerplate Clauses in International Commercial Contracts and the applicable law*, Cambridge University Press, p. 129-178 p. 133.

subtract from, or in any manner to vary or qualify the written contract”.<sup>71</sup> So any intentions of the parties not laid down written in the contract are not to be taken into account in the process.

Of course there are more implications about the interpretation of contracts from a common law approach. These interpretation rules are developed from case-based reasoning rather than deduced from a general principal.

### *7.1.2. Good Faith*

Along with the literal interpretation “good faith” might be understood as trust, belief or loyalty, an allegiance to a cause or a person, as for example "keep the faith" or "they broke faith with their investors”.

Historically the term good faith finds its origin in Roman law as the expression of *bona fides*.<sup>72</sup> It gave the judge an equitable discretion to decide the case before him in accordance with what appeared to be fair and reasonable.<sup>73</sup>

Good faith is a term that is not really originated in the English law. In the case *Interfoto Picture Library Ltd v. Stiletto Visual Programmes Ltd.*, judge Bingham explained this principle as follows:

“In many civil law systems, and perhaps in most legal systems outside the common law world, the law of obligations recognizes and enforces an overriding principle that in making and carrying out contracts parties should act in good faith. This does not simply mean that they should not deceive each other, a principle which any legal system must recognize; its effect is perhaps most aptly conveyed by such metaphorical colloquialisms as ‘playing fair’, ‘coming clean’ or ‘putting one’s cards face upwards on the table.’. It is in essence a principle of fair and open dealing.

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<sup>71</sup> Triebel and Balthasar, 2004, supra note 16, p.2191.

<sup>72</sup> Whittaker, S., Zimmermann, R., 2000, *Good Faith in European Contract Law*, Cambridge University Press, p. 16.

<sup>73</sup> Ibidem.

English law has, characteristically, committed itself to no such overriding principle but has developed piecemeal solutions in response to demonstrated problems of unfairness. Many examples could be given. Thus equity has intervened to strike down unconscionable bargains.”“At one level they are concerned with a question of pure contractual analysis, whether one party has done enough to give the other notice of the incorporation of a term in the contract. At another level they are concerned with a somewhat different question, whether it would in all the circumstances be fair (or reasonable) to hold a party bound by any conditions or by a particular condition of an unusual and stringent nature.”<sup>74</sup>

English law – as this quotation of the reasoning of judge Bingham JB in *Interfoto picture Library Ltd v. Stiletto Visual Programms Ltd.* shows – would rather tend to use the terms fairness and reasonableness, to explain why in certain cases a contract is not concluded or must be adjusted to fair standards.

As for “good faith” it tolerates a certain moral insensitivity in the interest of economic efficiency and values predictability of the outcome of a case more highly than absolute justice.<sup>75</sup>

From the English legal point of view there seems to be a tension between an overall principle of good faith which is understood as a principle to induce general reasoning about justice and therefore to give a judge the possibility to overrule the wording of a contract for the sake of absolute justice on the one hand; and on the other hand a non-application of such a principle and instead an interpretation of a contract along with its wording which serves the predictability of the outcome of a contract and in the overall perspective economic efficiency. Whittaker and Zimmerman express the idea that in the absence of a principle of good faith the making, performing or breaking of contracts is permitted by the law to be nasty and brutish with the parties entitled to flout all consideration of decency and fair play.<sup>76</sup>

Yet in many relevant cases the English law comes to similar results through the application of different doctrines such as equity,<sup>77</sup> the interpretation of a contract by paying regard to the

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<sup>74</sup> Bingham in: *Interfoto Picture Library Ltd v. Stiletto Visual Programmes Ltd.*, see also Peel, 2011, p. 134.

<sup>75</sup> Whittaker and Zimmermann 2000, see supra note 72, p. 7, with further references.

<sup>76</sup> *Ibidem*, p. 44.

<sup>77</sup> *Ibidem*.

parties' intentions,<sup>78</sup> the reasonable expectations of the parties<sup>79</sup> or "good faith" is being introduced by the law of particular contracts<sup>80</sup> and also statutory law.

One of the FIDIC contract provisions in which "good faith" is mentioned is the clause:

(...) **the Parties agree to negotiate in good faith** and make every effort to amend those provisions of this Contract, the amendment of which is expressly requested by the Financial Institutions as a condition for obtaining the necessary financing for the implementation of the project.

A clause to negotiate in good faith is a template that can be not only found in the concrete contracts we were analyzing but it is a typical boilerplate clause. It is also an underlying principle in the PECL, as sec. 3 art. 2:301: combines negative consequences in form of a liability for negotiations contrary to good faith.

#### **Article 2:301 PECL Negotiations Contrary to Good Faith**

- (1) A party is free to negotiate and is not liable for failure to reach an agreement.
- (2) However, a party who has negotiated or broken off negotiations contrary to good faith and fair dealing is liable for the losses caused to the other party.
- (3) It is contrary to good faith and fair dealing, in particular, for a party to enter into or continue negotiations with no real intention of reaching an agreement with the other party.

This is also a duty that is often formulated in boilerplate dispute regulation clauses, e.g., as follows:

If a dispute arises out of this contract, and if the dispute cannot be settled through negotiation, the parties agree **first to try in good faith to settle the dispute by mediation** before resorting to arbitration, litigation, or some other dispute resolution procedure.<sup>81</sup>

This term from an English law point of view seems to be quite problematic. A duty to negotiate in good faith has been described by the House of Lords in *Walford v. Miles* as

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<sup>78</sup> Ibidem, p.45.

<sup>79</sup> Ibidem, p. 46.

<sup>80</sup> Ibidem.

<sup>81</sup> <http://www.mccammongroup.com/services-mediation/alternative-dispute-resolution-clause.asp>, (last accessed 3. 7. 2013)



“inherently repugnant to the adversarial position of the parties when involved in negotiations’ and as ‘unworkable in practice’.<sup>82</sup> “The reason why an agreement to negotiate, (...) is unenforceable is simply because it lacks the necessary certainty. (...) How can a court be expected to decide whether, subjectively, a proper reason existed for the termination of negotiations? The answer suggested depends upon whether the negotiations have been determined “in good faith”. However, the concept of a duty to carry on negotiations in good faith is inherently repugnant to the adversarial position of the parties when involved in negotiations. Each party to the negotiations is entitled to pursue his (or her) own interest, so long as he avoids making misrepresentations. To advance that interest he must be entitled, if he thinks it appropriate, to threaten to withdraw from further negotiations or to withdraw in fact in the hope that the opposite party may seek to reopen the negotiations by offering him improved terms. A duty to negotiate in good faith is as unworkable in practice as it is inherently inconsistent with the position of a negotiating party. It is here that the uncertainty lies. In my judgment, while negotiations are in existence either party is entitled to withdraw from these negotiations, at any time and for any reason. There can be thus no obligation to continue to negotiate until there is a ‘proper reason’ to withdraw. Accordingly, a bare agreement to negotiate has no legal content.<sup>83</sup>

The outcome of this reasoning is especially problematic when it comes to the example of the dispute-settlement-clause given before. A mediation needs from the whole definition of the procedure good faith of the parties so that it can be successful. If such an ADR-clause under the English law would be invalid, it would have an impact on many contracts. Yet there have been other decisions about negotiations in good faith and different perception of “good faith” in other common law countries.

In the case *United Group Rail Services v Rail Corporation Of New South Wales* decided by the Australian NSW Court Of Appeal<sup>84</sup> the Court Rejected the "Walford v Miles" – Construction Of Dispute Resolution Clauses by arguing that a clause requiring senior representatives of the parties to "meet and undertake genuine and good faith negotiations with a view to resolving the dispute or difference" was not uncertain in law and was therefore valid and enforceable.

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<sup>82</sup> Whittaker and Zimmermann, 2000, see supra note 72, p. 7 with further references.

<sup>83</sup> Lord Ackner, 1992, in *Walford -v- Miles*.

<sup>84</sup> [2009] NSWCA 177.

In United States law the understanding of the principle of good faith is at least in commercial law different. The prerequisite of good faith serves as a basic overriding principle, especially in the UCC. It is essentially equitable in character. The UCC enables the jurist on several occasions to apply that equitable principle. Good faith in the case of a merchant means honesty in fact and the observance of reasonable commercial standards of fair dealing in trade (Section 2-103(1)(b)). If not especially related to merchants, good faith means honesty in the conduct or transaction concerned (Section 1-201(19)).<sup>85</sup>

### *7.1.3. Reasonableness*

In the English legal system in which precedent law dominates, reason is not only used as a criterion typical of traditional common law, but also as a general clause.

The English term ‘reason’ (*rozsądek*) according to Rott-Pietrzyk<sup>86</sup> has a wider scope of meaning than its Polish counterpart. The English term “reasonableness” (*rozsądny*) also means “just” (*śluszny*), “righteous, honest, fair” (*uczciwy*). One will not find connections between “reason” (*rozsądek*) and “rightness” (*ślusznosc*) in the Polish language as a criterion for assessments of conduct compliant with moral norms. What may be interpreted is only the connection with rationality of a specific action. In accordance with the definition formulated by Rott-Pietrzyk<sup>87</sup> “rational” (*racjonalny*) means “sensible; based on the proper thinking and effective in actions; justified, reasoned, and based on Latin *rationalis* means “reasonable” from *ratio* “account; judgment; reason, mind; method (...)”. The dictionaries of synonyms<sup>88</sup> give the following pair reasonable-rational. In the English language, in turn, “reasonable” differs from “rational” because the designate of the former, that is to say the referent, is also righteousness, which is not the designate of the latter term.<sup>89</sup> Therefore, it is assumed that “*racjonalny*” is more linked with logic and logical thinking/reasoning on the basis of a logical syllogism, whereas “*rozsądny*” refers to “practical human problems” and “remains something very close to equity”.<sup>90</sup>

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<sup>85</sup> Farnsworth 1995, see supra note 68.

<sup>86</sup> Rott-Pietrzyk, 2007, see supra note 11, p.10

<sup>87</sup> Ibidem.

<sup>88</sup> Kurzawa, Z. (ed.) 2004. *Słownik synonimów polskich*, Wydawnictwo PWN, S.A.

<sup>89</sup> Ibidem.

<sup>90</sup> Rott-Pietrzyk, 2007, see supra note 11, p. 11.

In American law being "reasonable" means to have capacity of reason, acting rationally or governed by reason. The behavior can be called "reasonable" if the activities can be valued as fair, just, or equitable. The person must be honest, moderate, sane, sensible, and tolerable. "Reasonable" implies a certain standard of valuation. It is a standard for guiding conduct. The person or his acts can be characterized as reasonable if he possesses the just-mentioned virtues. A fictitious standard is set up to evaluate human behavior.<sup>91</sup> The reasonable man test serves as a flexible concept, which needs to be interpreted by a constant shifting of the viewpoint between law and facts.<sup>92</sup>

## 7.2. Germany

### 7.2.1. General rules for the interpretation of contracts

The German contract, embedded into the completed statutory system, will be interpreted firstly by the wording, secondly out of the context, thirdly by the purpose and finally along with the history of his creation.<sup>93</sup> The premise of the interpretation of the contract is to find out the real intention of the parties and not to stick to the literal meaning of the expression (§ 133 BGB). This is a subjective-objective standard that pulls all the sources of evidence outside the contract, and that the entire contract and its individual provisions are to be interpreted in the way that good faith with regard to the common usage requires (§ BGB § 157 BGB). So this is understood as an objective standard of review that involves the environment around the contract, although it is perhaps not stated explicitly in the contract.

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<sup>91</sup>Joachim, W., 1992, *The Reasonable Man in United States and German Commercial Law*, 15 Comp.L.Yb. Int'l Bus. 1992, at 341 et seq, available under:< [www.trans-lex.org/124800](http://www.trans-lex.org/124800)>, [accessed 9. 7. 2013]. with reference to *The Rath Packing Company vs. Joseph W. Jones*, United States Court of appeals for the Ninth Circuit, 530 F.2d 1295 (1975).

<sup>92</sup> *Ibidem*, p. 360.

<sup>93</sup> Döser, see *supra* note 22, p. 1541, with further references.

## 7.2.2. Good Faith

### 7.2.2.1. The regulation

The principle of good faith (*Treu und Glauben*) literally: “fidelity and faith”<sup>94</sup> or also translated as: “faith and credit”<sup>95</sup> is regulated in the German Civil Code in different sections. The main rule is s. 242, yet it is also mentioned in s. 167, 162, 275 II, 307, 320 II and 815.

#### **Section 157, Interpretation of contracts**

Contracts are to be interpreted as required by good faith, taking customary practice into consideration.

#### **Section 242, Performance in good faith.**

An obligor has a duty to perform according to the requirements of good faith, taking customary practice into consideration.

Historically the before mentioned roman principle of *bona fides* could conveniently be blended with the indigenous notion of (*Treu und Glauben*) that can be found in a variety of medieval sources.<sup>96</sup>

### 7.2.2.2. Narrowing down the principle of good faith in German jurisdiction

In the German law systems s. 242 of the Civil Code is interpreted by the courts as an overall principle for the whole legal sphere which states that in making and carrying out his legal rights and obligations everybody should act in good faith.<sup>97</sup> The relationships in which good faith plays a role are not only obligational relations; any qualified social contact would lead to its application.<sup>98</sup> This includes relations that were founded by contract or legal regulation, relations that emerged out of a void contractual relation, contractual negotiations, long term business relations, etc.<sup>99</sup>

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<sup>94</sup> Whittaker and Zimmermann, 2000, see supra note 72, p.18.

<sup>95</sup> Farnsworth, 1995, see supra note 55, p. 68.

<sup>96</sup> Whittaker and Zimmermann, 2000, see supra note 72, p.18.

<sup>97</sup> Palandt, Grüneberg, C., 72nd ed., 2013, *Kommentar zum BGB*, C.H. Beck, München, s. 242, annotation 1.

<sup>98</sup> *Ibidem*, s. 242, annotation 5.

<sup>99</sup> *Ibidem*.

Although the principle of good faith is understood as an overall principle in many relations it has to be evaluated and concretized differently in different functional spheres.<sup>100</sup> The German courts and lawyers categorized its various fields of application and established typical ‘groups of cases’ (*Fallgruppen*) for the application of s. 242. Thus, it is generally recognized today that s. 242 operates to supplement the law (*supplendi causa*). It specifies the way in which contractual performance has to be rendered and it gives rise to a host of ancillary, or supplementary, duties that may arise under a contract: duties of information, documentation, co-operation, protection, disclosure, etc. These duties can also apply in the pre-contractual situation (*culpa in contrahendo*) and they may extend after the contract has been performed (*culpa post contractum finitum*). In the second place, s. 242 German Civil Code serves to limit the exercise of contractual rights. German commentators, in this context, very widely use the term “inadmissible exercise of a right” (*unzulässige Rechtsausübung*) as a *nomen collectivum* but they also frequently refer to “abuse of a right” (*Rechtsmissbrauch*) for instance in case someone is going against his own previous conduct.<sup>101</sup>

The general clauses of the German Civil Code (including of course the notion of “good faith”) are also a gate through which the values underling the constitutional basic rights can pass into the private law sphere. That is the core of the theory of the indirect force of constitutional basic rights provisions in private law. So with this penetrability of the public/private law barrier the private law is made more flexible to changing circumstances as, for example, a changing understanding of the human rights concept which follows social change.

From the German legal point of view the provision of the FIDIC contract “The Parties undertake to fulfill this Contract in good faith” would not need to be explicitly formulated in the contract, since it only restates the rule that is already mentioned in s. 242 BGB and this regulation is applicable to every contract.

The second clause of the FIDIC contract: “the Parties agree to negotiate in good faith“, matches with regulations already to be found under the German law. The obligation to negotiate in good faith is concretized by the principle of *culpa in contrahendo*. The mere entry into negotiations between i.e. a seller and a purchaser establishes a pre-contractual

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<sup>100</sup> Ibidem.

<sup>101</sup> Ibidem, s. 242, annotation 42; Whittaker and Zimmermann, 2000, see supra note 72.

relationship which imposes various obligations on the parties, regardless of whether or not an acquisition agreement is eventually signed. These obligations have been broadly defined to comprise duties of mutual consideration, care and loyalty resulting from the trust requested and provided by the parties. A negligent or intentional violation of pre-contractual obligations by the seller or the purchaser may result in a claim for damages by the other party, provided that it has actually suffered damage (principle of *culpa in contrahendo* or *Verschulden bei Vertragsschluss*).

Civil Code, s. 311, para. 2

(2) An obligation with duties under section 241 (2) also comes into existence by

1. the commencement of contract negotiations
2. the initiation of a contract where one party, with regard to a potential contractual relationship, gives the other party the possibility of affecting his rights, legal interests and other interests, or entrusts these to him, or
3. similar business contacts. (Negotiating the Acquisition Contract, Beinert / Burmeister/ Tries, 2009).

The rule of *culpa in contrahendo* which rooted in the thoughts of Rudolf v. Jhering<sup>102</sup> was firstly developed as a doctrine by the German Courts and was codified into the Civil Code as s. 311 only lately in the course of the reform of the law of obligations which entered into force in 2002.

Despite of the amendments of 2002 a wide body of case law defines in greater detail a number of pre-contractual obligations and is still relevant.<sup>103</sup> So each party is obliged to negotiate in good faith. Incorrect or misleading statements are likely to constitute a violation of such duty. The same holds true for the non-disclosure of material information which the party failing to disclose knows to be relevant to the other party's decision to enter into the transaction, and which a party negotiating in good faith would normally disclose.<sup>104</sup>

The pre-contractual obligation to negotiate in good faith does not, as such, require any party to sign the acquisition agreement and close the transaction. As long as no binding

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<sup>102</sup> Farnsworth, 1994, see supra note 68, p. 68 with further references.

<sup>103</sup> Beinert, D., Burmeister, F., Tries, H-J, 2009, *Mergers and Acquisitions in Germany*, C.H. Beck, München,

<sup>104</sup> Ibidem.

commitment has been made, either party may, in principle, walk away from the negotiations without becoming liable for damages.<sup>105</sup> Also a delay in the negotiations of the contract and the signing of the contract causes normally no liability.<sup>106</sup> However, where a party has caused the other party to believe that the contract will definitely be signed, in particular when agreement has been reached on all terms and conditions, breaking off negotiations without reasonable cause may give rise to a claim for damages by the other side. The damage to be compensated along with the principle of *culpa in contrahendo* would be comprised of any damages suffered in reliance on the completion of the contract, e.g., out-of-pocket expenses and damages suffered by not pursuing a realistic alternative transaction, but would not include lost profit under the contract in question.<sup>107</sup>

So in the stated FIDIC-Clause the overall obligation to undertake to fulfill the contract in good faith and the agreement to negotiate in good faith are somewhat repetitious of the obligations already valid under the civil code. Still the judiciary under the civil code has interpreted good faith for a long time and put it into certain case groups so that when incorporating this obligation into a contract one must bear in mind the meaning given to the term by the German judiciary.

### 7.2.3. Reasonableness

In German the legal equivalent for „reasonable man“ (literally translated: „*vernünftiger Mensch*“) would be: „*der verständige Rechtsgenosse*“.<sup>108</sup> In German law the reasonable man is adapted to various kinds of roles or professions, e.g., the reasonable consumer, the reasonable car driver, whose actions and opinion i.e. serve to judge which expenses as a result of a traffic accident are reasonable; the reasonable house owner, or the reasonable traveler, who carefully looks after his insured belongings.<sup>109</sup>

Beyond the question of the reasonable behavior of a person in a certain situation, human behavior in general will be evaluated in the sense of whether it is to be qualified as reasonable or not, when it comes to the definition of negligence. S. 276 (1) of the German

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<sup>105</sup> Ibidem.

<sup>106</sup> Palandt / Grüneberg, 2013, see supra note 97, s 311, annotation 35.

<sup>107</sup> Beinert / Burmeister / Tries, 2009, see supra note 103.

<sup>108</sup> Joachim, 1992, see supra note 91, p. 351.

<sup>109</sup> Ibidem, p. 352.

Civil Code states: “someone acts negligently, if he disregards due care”. To decide whether parties in a contractual or tortious situation (from the German point of view an obligation) acted with due care or not, the judge often calls on the hypothetical behavior of a reasonable man to obtain a sound platform for that decision.<sup>110</sup> To get to a result whether behavior is reasonable in a concrete situation, the flexible term of reasonableness has to be defined in more detail.<sup>111</sup>

Consider the FIDIC-Clause containing reasonableness:

“If and to the extent that any of those risks (specified risks defined to be in the sphere of the owner) above results in loss or damage to the works, Goods, (as the case may be), the Contractor shall (i) without undue delay give notice to the Owner and (ii) rectify this loss or damage to the extent that the rectification is possible by **commercially reasonable means** and instructed by the Owner.

Under German Law, this clause would be interpreted as follows: The interpreter would look for an objective standard of conduct in a given professional area. And in this case it might well be understood as a reasonable use of the rights from the contract, taking commercial standards into account.”

### *7.3. Poland*

#### *7.3.1. General rules for the interpretation of contracts*

The general clause for the interpretation of contracts is Art. 65 of the Polish Civil Code. It reads as follows:

Art. 65. Interpretation.

§ 1. A declaration of intent should be interpreted in view of the circumstances in which it is made as required by **principles of community life and established custom** (*zasady współżycia społecznego oraz ustalone zwyczaje*).

§ 2. In contracts, the common intention of the parties and the aim of the contract should be examined rather than its literal meaning.

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<sup>110</sup> Ibidem.

<sup>111</sup> Ibidem, p. 353.



The criteria for the interpretation of intentions or subjective wills are in line with the objective concepts to understand the content of declarations. The meaning of the will can be reconstructed on the basis of external, verifiable semantic rules associated with the context in which it comes to the expression of the will. It has to reconstruct the unanimous intentions of the parties.<sup>112</sup> The interpretation is based on objectified criteria and not on the subjective intent of the parties. Important is the matching intent of the parties and the purpose of the contract which is also evident based on objective, verifiable, external criteria.<sup>113</sup>

There are some special rules of interpretation for contracts. In the case of ambiguity or vagueness of a will in the form of a written paper, doubts should be resolved in favor of the person who has not edited the content (principle of *in dubio contra proferentem*).<sup>114</sup> This is concluded from the Decision of the Supreme Court from 18.3.2003 (IV CKN 1858-180). In this case the Supreme Court held that the principle of social coexistence, as an interpretation directive supports the thesis that the interpretation of unclear provisions of the general conditions of an insurance company must be interpreted against the insurance company rather than the insured person. Still the majority opinion rejects a generalization of that position. The facts of the judgment contained two important factors that influenced the decision: the person drafting the document was a professional, and the other party to the contract was a consumer and the document itself was a standard form, so this rule cannot be generalized.<sup>115</sup> In the Civil Code there are included a number of special rules of interpretation. Thus art. 71 specifies that an *invitation ad oferendum* in case of doubt has no binding force. Other rules of interpretation are regulated in art. 394 s. 1, 97, 544 s. 1 and art. 674.<sup>116</sup>

### 7.3.2. Good Faith

The term ‘good faith’ (*dobra wiara*) may be used in a subjective and objective sense. In the Polish Code of Contracts and Other Obligations (*Kodeks zobowiązań*) of 1933 the concept of good faith was used in both senses. In the objective sense, similarly to high morals, it

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<sup>112</sup> Safjan, M., in Pietrzykowski, K. (ed.), 5th. ed., 2008, *Kodeks cywilny, Tom I*, C.H.Beck Warszawa, Art. 65, annotation 2.

<sup>113</sup> Liebscher, M., Zoll, F., (ed.), 2005, *Einführung in das polnische Recht*, Schriftenreihe der Juristischen Schulung, C.H. Beck, München, p. 115.

<sup>114</sup> Ibidem.

<sup>115</sup> Osajda, K., 2012, Osajda, K., ed. *Kodeks cywilny. Komentarz*, C.H. Beck, Warszawa, Art. 65, annotation 8.

<sup>116</sup> Ibidem.

constituted a criterion of assessments of someone's conduct. For instance Article 189 of the Civil Code stated that 'the parties shall perform their obligations in accordance with their content, in a manner consistent with the requirements of good faith (...)'<sup>117</sup>. In the subjective sense, in turn, good faith refers to a psychological state of a given person who erroneously but due to justifiable reasons considers a law, a right or a legal state to exist. In that second sense the good faith is used especially in family law, law of succession and law of rights in rem. As far as the standards of conduct of persons concluding contracts are concerned, only the concept of good faith in the objective sense may be applied.<sup>118</sup>

In the applicable Polish Civil Code from 1964 that was generally amended during the transformation process in 1990, "good faith" is mentioned in Art. 7:

Art. 7. Presumption of good faith. If the law makes legal effects contingent upon good or bad faith, good faith is presumed.

Art. 7 hasn't been altered since 1964. Here we have an example of understanding good faith in the subjective sense, as a presumption on facts.

The general clause for the interpretation of contracts is Art. 65 of the Civil Code (stated above).

There are more places in the Polish Civil Code with reference to the mentioned vague phrases. These are the following:

Art. 5. Abuse of right. One cannot exercise one's right in a manner contradictory **to its social and economic purpose or the principles of community life** (*ze społeczno-gospodarczym przeznaczeniem tego prawa lub z zasadami współżycia społecznego*). Acting or refraining from acting by an entitled person is not deemed an exercise of that right and is not protected.

Art. 56. Effects of legal acts. A legal act gives rise not only to the effects expressed therein but also to those which stem from the law, **principles of community life** (*z zasadami współżycia społecznego*) and established custom.

Art. 58. Unlawfulness of an act.

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<sup>117</sup> *Strony winny wykonywać zobowiązania zgodnie z ich treścią, w sposób, odpowiadający wymaganiom dobrej wiary.*

<sup>118</sup> Rott-Pietrzyk, 2007, see supra note 11, 86-87.

§ 1. A legal act which is contrary to the law or which is designed to circumvent the law is invalid unless a relevant regulation envisages a different effect, in particular that the invalid provisions of the legal act be replaced with relevant provisions of the law.

§ 2. A legal act **contrary to the principles of community life** (*sprzecznna z zasadami współżycia społecznego*) is invalid.

§ 3. If only a part of a legal act is affected by invalidity, the remaining parts of the act continue to be effective unless it follows from the circumstances that without the invalid provisions, the act would not have been performed.

The adoption of these provisions was in 1964 a change from the legal situation in the inter-war period as the overall (objectively used) principle of good faith was replaced by the principle of social coexistence.

Difficulties connected with the interpretation (construction), translation and application of general clauses in contracts may lead to a situation in which they have different meaning depending on economic and regime-related laws in force in a given territory at a given time.

The clause of “*zasady współżycia społecznego*” that was taken directly from the (soviet) Russian civil law system replaced the traditional terms of reasonableness and good faith in 1964.<sup>119</sup> Art. 65 of the Polish Civil Code stayed unaltered until today, giving room to be interpreted along with truly most opposite state concepts.

During the communist time the principles of community life (*zasady współżycia społecznego*) were to be understood as moral rules and principles regulating inter human relations which are commonly accepted in a given period of time. During the communist regime the principles of community life were also guaranteed in art. 78 Polish Constitution.<sup>120</sup> Shortly after the entering into force of the Polish Civil Code there was a debate whether these principles of community life could overrule also binding provisions (*jus cogens*) of the Civil Code such as the record of a notary for the sales of land or termination of obligations.<sup>121</sup> The majority opinion rejected this notion. In the period after the rendering into force of the Civil Code they were interpreted by the Polish Supreme Court as norms of morals consistent with

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<sup>119</sup> Safjan M. 1990, *Klauzule generalne w prawie cywilnym (przyczynek do dyskusji)*, PiP vol. 11, p. 48.

<sup>120</sup> Gralla, E., 1966, *Die Generalklauseln im polnischen Zivilgesetzbuch*, JOR, vol.VII, 1966, p. 183-197, p. 190.

<sup>121</sup> Gralla, ibidem; Wolter, A., 1964, *Zasady współżycia społecznego w nowych kodeksach*, in: *Nowe Prawo*, vol. 11, p 1031-1042. p. 1031.

the opinion of the leading group of the society<sup>122</sup> which was a synonym for the communist party.<sup>123</sup> The Polish Supreme Court developed special principles grounded on the provisions of the Constitution such as the goals of the state, all constitutional principles or the prohibition of the abuse of rights and others.<sup>124</sup> These principles were meant to transform and to complete reality, to adopt the legal provisions to the new ideological and political needs.<sup>125</sup> So they were constructed to actively open up space for interpretation by the judges to give a wider scope of communist ideology into private law.

The role of the general clauses was seen as quite major in shaping the relation between the individual rights and the interest of the state.<sup>126</sup> The Polish legal concept of the principle of social co-existence/principle of community life (*zasady współzycia społecznego*) referred to in the Polish Civil Code is now again interpreted as the equivalent to the principle of “good faith” in the objective sense. After the transformation of the communist system into a democratic system the provision stayed the same but the interpretation along with the communist ideology was discontinued.

The clause of public policy as shaped by the communist legal system in Poland is still associated with a socialist moral doctrine despite the fact that it is used now in different circumstances and in a different reality and its content has also changed. It may be found in numerous provisions as an element that makes the content of particular institutions of civil law more flexible. It helps qualify some events leading to the creation of legal relations, for instance when interpreting declarations of will to prevent the occurrence of legal consequences which would be morally unacceptable (disapproved of and condemned) due to the particulars of the context.

Taking under regard the interpretation of the stated FIDIC-clauses it comes clear that under Polish law there exists an overall principle to interpret contracts and wills in accordance with the principle of social co-existence that is actually understood as “good faith”. Concerning the clause about negotiations in good faith it has to be mentioned that already during the

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<sup>122</sup> Decisions of the Polish Supreme Court of 13.12.1952 and 27. May 1962 published in: *Nowe Prawo* 1963, 7, 8-9)

<sup>123</sup> Gralla, E., 1966, *ibidem*, p. 195.

<sup>124</sup> *Ibidem*.

<sup>125</sup> Safjan, 1990, see *supra* note 101, p. 49.

<sup>126</sup> *Ibidem*, p. 48.

preparatory works for the law of obligations from 1933 it was stated that the general duty of loyalty and care in contract negotiations cannot be seen as a principal contractual obligation but merely as a supporting obligation.<sup>127</sup> But still the duty to negotiate in good faith was affirmed. In the actual Civil Code art. 72. s. 2 is the corresponding regulation:

Art. 72 (...)

§ 2. A party which enters into or conducts negotiations in breach of good custom, in particular without intending to execute a contract, is obliged to remedy any damage which the other party suffers by the fact that it was counting on the contract being executed.

Here again the general term of good custom is used but as stated before in a very similar interpretation as good faith.

### 7.3.3. Reasonableness

As said before the term “reasonable” (*rozsądny*) is in polish law not used in the sense of “rightness” (*słuszność*). It is rather interpreted as in connection with rationality in a specific way. The term reasonable (*rozsądny*) is not often used in polish law. It is used in the Civil Code i.e. in

art. 84. (Error)

§ 2. An error can only be relied on if it justifies the supposition that, if the person making the declaration of intent had not acted under the influence of the error and **had judged the case reasonably**, he would not have made such a declaration (material error).

and

art. 760<sup>2</sup> (Principal's obligations)

§ 2. The principal is obliged to notify the agent **within a reasonable time** of the acceptance or refusal of any proposal to execute a contract and of the non-performance of any contract executed with the agent's intermediary or which the agent has executed on the principal's behalf.

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<sup>127</sup> Cierpiał R., *Die polnische Regelung der Haftung aus Culpa in Contrahendo im Vergleich zu Deutschland und Österreich*, 2010, in Bachner, Th., Cierpiał, R., Lemanska, E., Liebscher, M., ed., Nomos, Baden Baden, p. 41-58, p. 48, with further reference.

§ 3. The principal is obliged to notify the agent **within a reasonable time** that the number of contracts the principal expects to be executed or their value will be significantly lower than that which the agent could normally have expected.

The examples show that the term is used in specific ways. In art. 84 the term “reasonable” is part of the legal definition of a material error. Reasonableness is important to distinguish the objective significance of the error, i.e. that a reasonable person who is familiar with the true state of the matter would not have submitted his declaration of intent to this effect.<sup>128</sup> So along with this definition an objective assessment of the significance of error will be considered. Here the reasonable person again is viewed as an average person who rationally decides how to act.

As regards the notion of “reasonable time” in art. 760<sup>2</sup> of the Civil Code, the law provides for the principal some flexibility in deciding how far in advance he has to inform the agent about a change of circumstance (in reasonable time).<sup>129</sup>

#### *7.4. China*

China enacted the Uniform Contract Law (UCL) in 1999, which intended to bring Chinese business practices into conformity with general Western practices. The UCL provides a supportive legal framework for international business transactions. Besides the UCL, the judicial interpretations from the SPC are important to the application of contract law in legal practice. The SPC issued Interpretation I, which came into effect on 29 Dec. 1999; and the Interpretation II, which became effective on 13 May 2009.

##### *7.4.1. Contract Interpretation*

Art. 125 of the UCL concerns contract interpretation and language versions. This is the first time that Chinese contract law introduced the system and principles of contract interpretation. This is essential to maintain freedom of contract, materialize contract justice, guarantee the

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<sup>128</sup>Judgement of the Supreme Court of 31.08.1989, III PZP 37/89, OSN 1990, No. 9, item. 108.

<sup>129</sup>Mikłaszewicz, P., 2012, Osajda, K., ed., 6th ed. *Kodeks cywilny. Komentarz*, C.H. Beck, Warszawa. 2012, art. 760<sup>2</sup> annotation 3.

will of parties and protect parties' contract purposes. There are certain rules and approaches towards contract interpretation; but eventually judges or arbitrators have the right to decide if there is any dispute between parties.

Art. 125 states that “in case of any dispute between the parties concerning the construction of a contract term, the true meaning thereof shall be determined according to the words and sentences used in the contract, the relevant provisions and the purpose of the contract, and in accordance with the relevant usage and the principle of good faith.”

It also provides that “when a contract was executed in two or more languages, and it provides that all versions are equally authentic, the words and sentences in each version are construed to have the same meaning. In case of any discrepancy in the words or sentences in the different language versions, they shall be interpreted in light of the purpose of the contract.”

From this provision, we can identify that UCL adopts the “Plain meaning” rules; “purpose” construction approach; custom, the principle of good faith; and the principle of “being interpreted as a whole”.<sup>130</sup> However, the provision has been criticized as too simple, omitting concrete elements applying to each interpretation approach. Such method may lead to controversy and increased uncertainty for transacting parties.<sup>131</sup>

In addition, art. 41 prescribes for disputes concerning the construction of a standard form, the terms shall be interpreted in accordance with common sense. If a standard term is subject to two or more interpretations, the interpretation that is unfavorable to the party that supplies it shall be adopted. If a discrepancy exists between the standard term and a non-standard term, the non-standard term prevails. Although art. 41 particularly concerns construction of standard terms, it actually points out the typical contract interpretation approach of “common sense” and also one special “unfavorable explanation rule” regarding standard terms.

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<sup>130</sup> Liang, Huixing (2001), *Contract Interpretation Method and the so-called “Right of Final Interpretation”*, Institute of Law, Chinese Academy of Social Scientist, available at <http://www.iolaw.org.cn/shownews.asp?id=1484>, accessed 15 Mar. 2013. (In Chinese language).

<sup>131</sup> Qiao, Xincheng (2001) *Discussion on Contract Interpretation*, published on 30 Nov. 2001, available at <http://www.people.com.cn/GB/guandian/29/173/20011130/616647.html>, accessed 14 Mar. 2013. (In Chinese language).

#### 7.4.2. Good Faith

Good faith, freedom of contract, and fostering transactions are three fundamental and guiding principles in Chinese contract law. In the UCL, “the principle of good faith” in Chinese language refers to the term “*chengshixinyong*” (literally “honesty and trustworthiness”, often abbreviated into “*chengxin*”). This principle requires parties to conduct themselves honorably, to perform their duties in a responsible manner, to avoid abusing their rights, to follow the law and common business practice, and so forth.<sup>132</sup>

UCL recognizes this principle at every stage of a transaction (contract formation, after contract formation and before contract performance, contract performance, termination of a contract). For example, art. 6 provides this principle of good faith in general, and requires the parties to abide by the principle in exercising their rights and performing their obligations. Art. 42 states the pre-contract liabilities for damages that a party may bear, if in the course of concluding a contract, the party engaged in some conducts that caused loss to the other party. The circumstances of such conducts are (i) negotiating in bad faith under the pretext of concluding a contract; (ii) intentionally concealing a material fact relating to the conclusion of the contract or supplying false information, (iii) any other conduct which violates the good faith principle. Art. 60 concerns that the parties shall abide by the principle of good faith, and perform obligations in light of the nature and purpose of the contract, and in accordance with the relevant usage. Art. 92 refers to the principle of good faith upon discharge of the rights and obligations under a contract.

Concerning translation, it seems that there are two different English translations (principle of good faith, and “honesty and trustworthiness”) for the Chinese phrase “*chengshixinyong*”. However, Cao claimed that different translations may have different implications; and this also exemplifies the problem in translating Chinese law into English.<sup>133</sup> In the Chinese contract law, the phrase “*chengshixinyong*” was actually translated from the English “good faith” under common law; thus when the Chinese phrase was translated back to English, its meaning seems equivalent to the English “good faith”.<sup>134</sup> But Chinese phrase

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<sup>132</sup> Wang, Liming and Xu, Chuanxi (1999) *Fundamental Principles of China's Contract Law*, 13 Columbia Journal of Asian Law, (1999), Issue 13, 16.

<sup>133</sup> Cao, Deborah. (2004) *Chinese law: A Language Perspective*. Hants, England: Ashgate Publishing Limited, 12-13,

<sup>134</sup> *Ibidem*.



“*Chengshixinyong*” or “*Chengxin*” also has its own root in the Chinese cultural tradition, which refers to Confucianism, Mohism, Taoism, Legalism, and Buddhism.<sup>135</sup> Accordingly, to apply and interpret “*chengxin*” or other contract law terms in a proper manner may require the consideration of current Chinese legal practice.<sup>136</sup>

#### 7.4.3. Fair dealing or “fairness”

Fairness, in Chinese terms, refers to “*gongping*”. However, the Chinese concept of “*gongping*” can have different meanings or translations in English language such as “unbiased”, “equitable”, “impartial”, “reasonable”, or “rational”. The UCL recognizes the fairness principle, which refers to article 5 requiring the parties to abide by such principle in prescribing their respective rights and obligations. The principle is also applied in standard terms provisions (art. 39 requires the party supplying the standard terms to obey such principle in prescribing the rights and obligations of the parties). Sometimes, the adjective word “fair”, which describes a certain manner or way, is used. For example, art. 271 concerns the tendering process in construction project, and requires the tender to be conducted in an open, fair and impartial manner according to relevant laws.

The application of the principle “fairness” can be closely connected with “good faith”. For example, a letter from the SPC in 1992 (No. 27), concerned a contract dispute on sales of gas meter spare parts. The contract price of the main component material was 4400 RMB per ton, but later the price increased to 4600, and then to 16000 RMB. The SPC considered that this was a kind of change of circumstances that the parties could not foresee and could not be avoided, during the performance of the contract. Hence it would be “unconscionable” or very unfair to the sales party to perform the contract according to the original contract price. Some commented that this case represented that the SPC had accepted the concept of “unconscionability” and the principle of “changes of circumstances”. Some considered that the principle of change of circumstances is a specific case of application of “good faith” in contract law.<sup>137</sup>

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<sup>135</sup> Cao, Deborah. (2004), 169.

<sup>136</sup> *Ibidem*.

<sup>137</sup> Zheng, Qiang (2000) *A Comparative Study of Principle of Good Faith in Contract Law*, Journal of Comparative Law, (2000), Issue No. 1. (In Chinese language).

Nowadays the principle of change of circumstances is clearly recognized in China. The recent Judicial Interpretation II of Contract law in 2009, art. 26, particularly specifies the principle of change of circumstances. According to this provision, if any major change occurs which is unforeseeable when the parties concluded a contract; is not a business risk and is not caused by force majeure occurs after the formation of the contract; if the continuous performance of the contract is obviously unfair to the other party or cannot realize the purposes of the contract; and a party files a request for the modification or rescission of the contract with the court, then the court shall decide under the principle of fairness and in light of the facts of the case.

#### *7.4.4. Reasonableness*

Reasonableness in Chinese language usually refers to “*heli*”. Interestingly, the Chinese phrase “*heli*” can be understood as “rational”, “reasonable”, “fair”, “equitable” in English language. Considering the overlap of the meanings of concepts of “fairness” and “reasonableness” in Chinese language, there can be problems of choosing a proper phrase when doing the translations.

Looking at the UCL, one can find phrases containing “reasonable”, such as “reasonable time”, “reasonable period”, “reasonable manner”, “be shared in a reasonable manner” in many articles. The usage of “reasonable” can be classified in two ways. Firstly, it is used to describe “period”, or “time limit”. For example, art. 23 provides if the offer does not prescribe a period for acceptance, and if the offer is made in a non-oral manner, the acceptance shall reach the offeror within a reasonable time. Similarly, art. 69 states that “after performance was suspended, if the other party fails to regain its ability to perform and fails to provide appropriate assurance within a reasonable time, the suspending party may terminate the contract”.

Secondly, it is used as a modifier of a noun or a verb according to the specific requirements of concrete provisions. The use of “reasonable” or “reasonably” limits or defines the degree and scope of using, understanding or grasping the noun or verb. Art. 289 requires that a common carrier may not deny any normal and reasonable carriage requirement by a passenger or consignor. According to art. 332, a developer in commissioned development

shall use development funds in a reasonable manner. Such expressions can also be seen in business contracts in China.

It is generally accepted that legal provisions should use precise wording to ensure the clear meaning. And vague words should be avoided, because vague or ambiguous phrases cause misunderstanding and difficulties of application. But then a question arises: would the word “reasonable” used in contract law and contracts lead to disputes, and thus be avoided?

One Chinese scholar has written that the use of “reasonable” in contract law can be positive from four perspectives. First, the term to some extent makes up for limitations on predictability of legislation; secondly, the frequent use of the term reflects party autonomy; thirdly, the word implies compliance with public order and good morals and respect towards trading custom or habits between parties in certain industries; finally, it reflects the application of the good faith principle.<sup>138</sup> We also understand the reason and advantages of employing the term “reasonable” in contract law. However, we still would recommend that business parties specify concrete time periods, and try to avoid the usage of the term in contract documents in practice, if they can.

## 8. Summary

Flexibility in contracting can be achieved by using vague terms. There are some vague terms that are well known in the laws of given countries and international contract templates. The examples chosen here, the terms good faith and reasonableness, relate to different law families. As the term “good faith” can be understood as the translation of the original roman term “*bona fides*” and the term “*Treu und Glauben*” that is deeply rooted in German legal history, this term actually originates from the civil law family. As the examples of the laws of Germany, Poland and China show, they establish an overall principle that is not only relevant to the interpretation of contracts and the concretization of secondary obligations of a contract, but concern also the way the negotiation of the contract shall be conducted. The term “good

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<sup>138</sup> Xu, Lingjie (2001) *Rationality of Rationalization in the Contract Law*, Journal of Yunan University (Law Edition), (2001), Issue 4. (In Chinese language).

faith” though often explicitly referred to in boilerplate clauses that are part of a business contract, is in these countries also part of the civil code.

On the contrary in common law countries generally, there is no overall principle applying contracts with ”good faith”. Under a common law system the notion of ”good faith” in a contract makes sense to complete the general obligations arising from the contract, but even this may not be completely observed in English case law.

This position, however, points to only one of the opposite ends regarding the application of ”good faith” under a common law family law system. The other end is marked by the US law where in the restatements and in the UCC the term ”good faith” is frequently used.

When it comes to the term of ”reasonableness” it is rather the other way around. This term originates rather in common law but has been adopted in the civil law systems. While in the common law the term ”reasonableness” seems to have a general meaning, in the state laws of the civil law system such as Poland the term is used in a narrower sense.

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# The Principle of Loyalty and Flexibility in Contracts

PETRA SUND-NORRGÅRD,<sup>1</sup> ANTTI KOLEHMAINEN,<sup>2</sup> ONERVA-AULIKKI SUHONEN<sup>3</sup>

Flexibility is needed especially in long-term cooperative agreements, which should work over time and adapt to changing circumstances. The aim of this article is to highlight how the Nordic principle of loyalty can facilitate the conclusion of more flexible contracts. The method used is the traditional legal method (Rechtsdogmatik).

The principle of loyalty, the Nordic equivalent to the principle of good faith in the civil law countries of Continental Europe, requires that the parties to a contract have due regard to the other party's interests during the contract negotiations and performance, but also after the contract has been executed. The principle of loyalty may, for example, oblige a party to inform the other party of issues that are relevant for his performance or require renegotiation of the contract due to changing circumstances. By clarifying for the parties the behaviour that can be expected of them, as well as what they can expect from others, the principle of loyalty facilitates trust and makes it easier for parties to dare enter into more flexible contracts. The parties can also ascertain that the principle of loyalty will be given weight in the interpretation of the contract through their drafting technique, as we show in the article.

Flexible, long-term contracts are likely to include gaps and leave room for interpretation, which increases uncertainty. In the article we argue that the principle of loyalty proves to be beneficial in these situations. As the principle of loyalty functions as a legal basis for protection of the parties' legitimate expectations, the gaps of the contract can often be filled with what is perceived as "normal" for the type of contract within the said trade. This reduces the need for highly detailed, complete contracts.

As a result, the knowledge of the existence of the principle of loyalty might support the parties' choice to conclude a flexible contract.

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<sup>1</sup> Postdoctoral researcher (Academy of Finland) at the University of Helsinki, Finland.

<sup>2</sup> Professor of family and inheritance law, University of Eastern Finland, Joensuu, Finland.

<sup>3</sup> Lecturer of civil law, University of Eastern Finland, Joensuu, Finland.

## 1. Introduction

Good contracts are needed in commerce. By this we mean well-working contracts from the parties' perspective. Since many commercial contracts are typically long-term cooperative arrangements, they should be flexible enough to work over time and changing circumstances.

A well-working contract can also contain open questions, perhaps even conscious gaps, since the parties have decided to modify their contract to the extent needed during its term. The reason for such a decision can be strictly economic: If the parties trust one another it is easier, faster and cheaper to conclude a more rudimentary contract. Real-life contracts do not always, however, contain the flexibility needed in the form of, for example, clauses on renegotiation, hardship and alternative dispute resolution (ADR).

The main objective of this article is to highlight that the so called principle of loyalty in Nordic contract law can promote the use of flexibility in contracts. This follows from the principle's function of building trust between the parties, wherefore it can hinder opportunistic behaviour. And trusting parties dare enter into more flexible contracts. In other words, we find that the principle of loyalty is a helpful norm when it comes to flexibility in contracts.

## 2. The Principle of Loyalty as a Nordic Phenomenon

The principle of loyalty, the Nordic equivalent to the principle of good faith in the civil law countries of Continental Europe, refers to the set of obligations, which contracting parties have towards each other. Similarly to the good faith principle (or "*Treu und Glauben*" and "*bonne foi*" principles) the principle of loyalty requires that the parties to a contract have due regard to the other party's interests during the contract negotiations and performance, but also after the contract has been executed. The principle of loyalty promotes the realisation of an agreement by directing behaviour so that the other party's reasonable expectations will be met.<sup>4</sup>

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<sup>4</sup> Taxell, L.E. (1972), *Avtal och rättsskydd*, Åbo Akademi, p. 81, Ämmälä, T. (1994), "Lojaliteettiperiaattesta eräiden sopimustyyppien yhteydessä", in Saarnilehto, A. (Ed.),

The principle of loyalty is primarily focused on behaviour and not actual contract terms.<sup>5</sup> Parties are, for example, obliged to contribute to the realisation of common goals and refrain from causing harm to the other party, while fairness or unfairness of the contract itself is to be resolved under the principle of conscionability found in Section 36 of the Contracts Act: “If a contract term is unfair or its application would lead to an unfair result, the term may be adjusted or set aside.”

The Nordic principle of loyalty is moreover characterised by its close connection to other contract law principles, for example the aforementioned principle of conscionability. As it does not diverge clearly from other contractual principles it cannot be exhaustively defined, but its content should be determined instead *in casu*.<sup>6</sup>

The principle of loyalty as such cannot be found in any laws in Finland, but many sections of different laws have been linked to the said principle and it has also been recognised in certain *travaux préparatoires* (preparatory work on legislation). The principle of loyalty is recognised in decisions by courts and arbitration panels as well as in contract practices. Today most scholars consider it an existing general principle of law, that is a legal principle acceptable according to the values of society.<sup>7</sup> Rules and principles are both legal norms. As a legal rule can be described with the expression “either–or”, which means that the rule either comes into effect in a certain situation or it does not, a legal principle is, however, more correctly described with the expression “more–or–less”. This means that the principle can come into effect to a different extent in different situations.<sup>8</sup>

Although the principle of loyalty has been then generally accepted in Finland, its actual

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*Lojaliteettiperiaatteesta – Vastapuolen edun huomioon ottamisesta eri oikeudenaloilla*, Turun yliopiston oikeustieteellisen tiedekunnan julkaisuja, Turku, pp. 3–50 (pp. 4–9), Munukka, J. (2007), *Kontraktuell lojalitetsplikt*, Jure Förlag AB, Stockholm, pp. 73–101.

<sup>5</sup> Munukka J. (2005): “Harmonisation of Contract Law: In Search of a Solution to the Good Faith Problem”, *Scandinavian Studies in Law*, pp. 229 – 250 (p. 242).

<sup>6</sup> Taxell (1972), pp. 75–82, Ämmälä (1994), pp. 10–11, Karhu J. (2008): “Lojaliteettiperiaate sopimusoikeudessa – oikeudellista peruskartoitusta”, in *Juhlajulkaisu Leena Kartio 1938 – 30/8 – 2008*, Suomalainen lakimiesyhdistys, Helsinki, pp. 101 – 116 (p. 103).

<sup>7</sup> Sund-Norrgård P. (2011), *Lojalitet i licensavtal*, Publications of IPR University Center, Juridiska föreningens publikationsserie nr 56, Helsinki, p. 58 and references.

<sup>8</sup> Dworkin, R. (1978), *Taking Rights Seriously*, Harvard University Press, Cambridge, pp. 22–28, 71–80, Aarnio, A. (1989), *Laintulkinnan teoria, Yleisen oikeustieteen oppikirja*, WSOY, Helsinki, pp. 78–83, Peczenik, A. (1995), *Juridikens teori och metod*, Fritzes Förlag, Stockholm, p. 75, Tuori, K. (2008), *Rättens nivåer och dimensioner*, Yliopistopaino, Helsingfors, p. 55.

content, theoretical basis and applicability has been quite widely debated.<sup>9</sup> The situation seems to be similar in the other Nordic countries, where the principle of loyalty also lacks a clear statutory basis. For example in Sweden it has been unclear whether the principle of loyalty should be considered a general contract law principle or whether its applicability is limited only to some types of contracts.<sup>10</sup>

In this article we have chosen to use the term principle of loyalty instead of good faith to emphasise the Nordic point of view while approaching the discussion about flexibility. This term corresponds to the Finnish “*lojaliteettiperiaate*”, Swedish “*lojalitetsprincip*”, and Norwegian and Danish “*loyalitetprincip*”.

### 3. “Complete” contracts v. flexible contracts

#### *3.1. The importance of legal and business knowledge in contract drafting*

Contracts are often drafted by businessmen without any help from lawyers, and many times this works very well. It is, however, always a good thing to remember that even the simplest contract is in essence a legal construction.

A businessman concluding, for example, contracts on sale of real property in Finland without legal help, needs to know the content of the Finnish Code of Real Estate anyway. This follows from the simple fact that if a sale of real property is not concluded in accordance with the mandatory provisions of the said Code, the sale is considered null and void.

It is also a fact that if parties in a given situation – not requiring compliance to mandatory rules – do not use their freedom of contract, a judge will apply default rules, should the parties ever end up in a courtroom or arbitration. In other words, in order to make informed decisions on how to use their freedom of contract the parties need to know what might follow if they do not. It is therefore often a good idea to involve lawyers in the contract drafting

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<sup>9</sup> Muukkonen, P.J. (1993) ”Sopimusoikeuden yleinen lojaliteettiperiaate”, *Lakimies*, pp. 1030–1048 (pp. 1033, 1039–1040), Mähönen J. (2000b): “‘Good Faith and Fair Dealing’ ja lojaliteettivelvollisuus”, in *Juhlajulkaisu Tuula Ämmälä 2.11.2000*, Turun yliopiston oikeustieteellisen tiedekunnan julkaisuja, Turku, pp. 203 – 231 (pp. 222–223).

<sup>10</sup> Munukka (2005), pp. 235–238, Munukka (2007), pp. 10, 62.

process.

Before any contracts are to be concluded, the businessmen and their lawyers should “educate” one another. The businessmen should convey information on the business to the lawyers; this can be especially important for companies that lack in-house counsels and therefore need to seek outside legal help from people more unfamiliar with their business. It is likely that lawyers who do not understand the business are of less use to the businessmen than lawyers who do. Lawyers, on the other hand, should convey information on the law to the businessmen, since no contract is concluded in total detachment from the background law. This is so even though contracts have many functions, many of them certainly non-legal ones.

### *3.2. The contract should work for the parties*

When a contract is to be concluded, the businessmen and their lawyers should think proactively. In order to end up with a well-working end product, they should avoid drafting contracts that could be described as mechanical and stereotyped in favour of more conscious and goal-oriented ones that actually work for the parties. This means that the parties’ intentions, goals, and expectations must be made clear, after which the drafting technique should be chosen accordingly.<sup>11</sup>

If the parties feel the need to focus on risk allocation, a detailed, complete contract covering most, if not all, aspects of the transaction might be optimal. This may be the case if the parties do not know one another and therefore do not trust one another, and they are about to conclude a short-term contract in a situation where the circumstances are stable. On the other hand, if the parties are about to enter into a long-term, close cooperation based on trust, in a situation where the circumstances are unstable and alter rapidly, it is likely that a detailed, complete contract with rigid terms will lack the flexibility needed and therefore make the

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<sup>11</sup> Pohjonen, S. (2005): ”Ennakoiva oikeus – dialogista oikeutta”, in Pohjonen, S. (Ed.), *Ex ante – ennakoiva oikeus*, Talentum, Helsinki, pp. 11–44 (pp. 12–13), Haapio, H. (2007), ”An Ounce of Prevention... – Proactive Legal Care for Corporate Contracting Success”, *Tidskrift utgiven av Juridiska Föreningen i Finland*, pp. 39–68 (pp. 40, 50–51), Pohjonen, S. (2009): ”Law and Business – Successful Business Contracting, Corporate Social Responsibility and Legal Thinking”, *Tidskrift utgiven av Juridiska Föreningen i Finland*, pp. 470–484 (pp. 477–478).

cooperation more difficult. As a result, the contract might work only if its wording is *not* followed, that is if the parties decide to apply the contract in a flexible manner even though the contract itself does not allow it. Surely businessmen, as well as their lawyers, must strive for better contracts than that.<sup>12</sup>

It also needs to be pointed out that in many situations it is not even possible to draft a complete contract without gaps. Not only will it be too expensive to try to cover every aspect of the transaction, it will be impossible, since the future cannot be foreseen. Instead the cooperating parties will benefit from a more flexible contract that can be modified to the extent needed during its term. Since the parties strive for something more than short-term profit, they cooperate and focus on the principal aims of the contract. Keeping track of possible minor details in the contract is perceived as less important.<sup>13</sup> Since the parties depend on one another, it is also usually in both their interests to keep the contract in force. Therefore, it is logical for them to solve problems through discussion and negotiation if, and when, they occur.<sup>14</sup>

Anyhow, it is essential that parties think things through before concluding a contract. If you feel that the other party really can be trusted and you see yourself as cooperating smoothly for many years towards a common goal, flexibility is probably the right way to go. On the other hand, if you have doubts and feel that profound problems are possible in the future, flexibility can indeed be risky. In such a case short-term contracts with more rigid terms are probably better; for example a well-designed liability clause can be of great help in cases like these. The true difficulty in contract drafting lies therefore in finding the right balance, for the situation at hand, between certainty/security and flexibility.

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<sup>12</sup> Sund-Norrgård (2011), pp. 100–103.

<sup>13</sup> Nassar, N. (1995), *Sanctity of Contracts Revisited. A study in the Theory and Practice of Long-Term International Commercial Transactions*, M. Nijhoff, Dordrecht, London (etc.), pp. 21–23, 218–219, Grönfors, K. (1995), *Avtal och omförhandling*, Nerenius & Santérus Förlag AB, Stockholm, pp. 22–23.

<sup>14</sup> Pöyhönen, J. (1988), *Sopimusoikeuden järjestelmä ja sopimusten sovittelu*, Suomalainen Lakimiesyhdistys, Helsinki, pp. 211–213, Nassar (1995), pp. 67, 71–73, 218–219, Nystén-Haarala, S. (1998), *The Long-Term Contract. Contract Law and Contracting*, Kauppakaari Oyj Finnish Lawyers' Publishing, Helsinki, pp. 8, 27, 35, Macneil, Ian R. (2001), *The Relational Theory of Contract: Selected Works of Ian Mcneil*, David Campbell (ed.), Sweet & Maxwell, London, p. 197.

#### 4. How the principle of loyalty makes flexibility easier

Since the principle of loyalty is considered part of Nordic contract law this can in fact facilitate the conclusion of more flexible contracts. This assertion essentially follows from the notion that the principle of loyalty may help increasing trust between the parties.<sup>15</sup> Namely, as long as the content of the principle of loyalty is not perceived as too vague and imprecise, it may help clarifying for the parties the behaviour that can be expected of them, as well as what they can expect from others. The parties have a moral, as well as a legal, duty to act in accordance with such “business sense”.

When talking about the legal duty to act in accordance with the principle of loyalty it is nonetheless a question of debate whether a breach of the said principle in fact constitutes a breach of contract followed by sanctions, or if the principle is somehow weaker than that. Support for the view that a breach of the principle of loyalty in itself may constitute a breach of contract is found in the legal doctrine,<sup>16</sup> as well as in decisions KKO 1993:130, KKO 2007:72 and KKO 2008:91 of the Finnish Supreme Court. There are also scholars who view breach of contract and breach of the principle of loyalty as separate issues.<sup>17</sup>

The content of the principle of loyalty is essentially based on so called legitimate expectations. For example an existing trade custom in the market in question can be relevant as to what can be expected based on it. This follows from the notion that a party to a contract, as a starting point, is entitled to expect the other party to act in a way perceived as “normal” for the type of contract in question within the said trade. As a result, the expectations of what follows from the application of the principle of loyalty vary.<sup>18</sup>

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<sup>15</sup> Mähönen (2000b), pp. 213–215, Sund-Norrgård (2011), p. 106.

<sup>16</sup> Muukkonen, P. J. (1975), ”Yhteistyösopimukset ja lojaliteettivelvollisuus”, in Hoppu, E. et al (Ed.), *Juhlajulkaisu Urho Kaleva Kekkone, 1900 – 3/9 – 1975*, Suomalainen Lakimiesyhdistys, Helsinki, pp. 356–364 (p. 364), Pöyhönen (1988), p. 19, Nicander, H. (1995–96), ”Lojalitetsplikt före, under och efter avtalsförhållanden”, *Juridisk Tidskrift vid Stockholms universitet*, pp. 31–49 (pp. 33, 36), Sund-Norrgård (2011), pp. 280–281.

<sup>17</sup> Aurejärvi, E. (1993), ”Virallisen vastaväittäjän professori Erkki Aurejärven Turun yliopiston oikeustieteelliselle tiedekunnalle antama 14.9.1993 päivätty lausunto Ari Huhtamäen väitöskirjasta Luotonantajavastuu, Lender Liability Suomessa – velvoiteoikeudellinen tutkimus luotonantajan vastuusta luotonottajaa kohtaan erityisesti USA:n oikeuteen verrattuna”, *Lakimies*, pp. 1095–1127 (p. 1102), Mononen, M. (2001), *Sopimusoikeuden materiaalisuudesta*, Helsingin yliopiston verkkojulkaisut – e-thesis, Helsinki, p. 164.

<sup>18</sup> Nassar (1995), pp. 190, 237, Nazarian, H. (2007), *Lojalitetsplikt i kontraktsforhold*, Cappelen Akademisk Forlag, Oslo, pp. 316–317.

The notion that one should not deviate from what is considered normal behaviour may very well be helpful in the building of trust between the parties, which in itself might suppress a possible temptation to behave in a short-term opportunistic way. Since cooperation within long-term contracts normally cannot work without trust, trust is rational.<sup>19</sup> And it is certainly easier to trust someone if the risk of being let down is considered small.<sup>20</sup> The assessment is then essentially based on the interests of the party one intends to trust: the likelihood of him acting in a favourable manner – or at least not in a harmful manner – is considered high enough for you to contemplate cooperation with him.<sup>21</sup> A party that needs the other party in order to reach a certain goal will be less tempted to act in a short-term opportunistic way, and will therefore also be more trustworthy.

In a situation where contract parties trust one another they lack the need to safeguard against opportunistic behaviour. This means that they also lack the need to strive for contracts covering every possible aspect of their transaction, and can settle for more flexible, and probably cheaper, contracts instead.

In sum, even though the content of the principle of loyalty may seem somewhat vague, it really does exist. It is a “real” norm that can be helpful, for example, in the contract drafting.

## 5. How to use the principle of loyalty to make contracts flexible

Since the purpose of the judicial system cannot be to protect disloyal behaviour, the principle of loyalty is considered a prescriptive norm that always applies.<sup>22</sup> This means that freedom of contract is limited by the principle of loyalty, and not the other way around. Such a conclusion can be drawn also from Article 1:201 in PECL, Article 1.7 in Unidroit Principles and DCFR III. – 1:103, according to which the principle of *good faith and fair dealing* is

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<sup>19</sup> Nystén-Haarala (1998), p. 33.

<sup>20</sup> Nooteboom B. (2002), *Trust. Forms, Foundations, Functions, Failures, and Figures*, Edward Elgar Publishing, Great Britain, p. 37.

<sup>21</sup> Gambetta, D. (1988), “Can We Trust Trust?”, in Gambetta, D. (Ed.), *Trust. Making and Breaking Cooperative Relations*, Basil Blackwell, Oxford, pp. 213–237 (pp. 217–218), Dasgupta, P. (1988), “Trust as a Commodity”, in Gambetta, D. (Ed.), *Trust. Making and Breaking Cooperative Relations*, Basil Blackwell, Oxford, pp. 49–72 (pp. 50–51), Hardin, R. (1992), “The Street-Level Epistemology of Trust”, *Analyse & Kritik*, pp. 152–176 (pp. 152–153).

<sup>22</sup> Holm, A. (2004), *Den avtalsgrundade lojalitetsplikten – en allmän rättsprincip*, Linköpings universitet, Linköping, p. 18.



mandatory and may not be excluded or limited by contract. This is, however, mainly true for the moral foundations of the principle of loyalty,<sup>23</sup> since the contract itself also has an impact on the content of the principle of loyalty; this is true for PECL and DCFR as well.<sup>24</sup> So, although the principle of loyalty cannot – and should not – be avoided, the content of a contract concluded between parties of equal bargaining power can have an impact on what, in their case, is to be considered loyal behaviour.<sup>25</sup>

From this notion one can draw the conclusion that if the parties' contract can be understood rather as a framework for a flexible process of on-going cooperation than as a device for precise risk allocation, the principle of loyalty will have a greater significance in the interpretation of the contract. A contract of this kind shows that the parties have a need for loyal behaviour and trust, since they depend upon each other and therefore are more vulnerable. Through the drafting technique it is then possible (within certain limits) to effect the functions of the contract. The parties can, for example, ascertain that the principle of loyalty will be given weight when there are gaps in the contract that have to be filled, or when the contract has to be interpreted by a third party.

Occasionally also parties engaged in long-term cooperative arrangements cannot solve their problems through negotiations. Even though it is usually not recommendable to take a dispute all the way to court proceedings or arbitration, this certainly happens sometimes. We need therefore to address the question of what happens when a more rudimentary, flexible contract is to be interpreted for example in court. That is, when the purpose of the contract/the common goal of the parties is to be identified.

When a contract is interpreted, the purpose of the contract prevails. This is true also for a situation where the purpose contradicts a contract's wording (if the purpose can be identified). This notion does not, however, change the fact that the wording of the contract

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<sup>23</sup> Nazarian (2007), p. 136.

<sup>24</sup> *Principles of European Contract Law, Parts I and II* (2000), Prepared by The Commission on European Contract Law, Lando, O. and Beale, H. (Ed.), Kluwer Law International, The Hague, London, Boston, p. 116, *Draft Common Frame of Reference (DCFR)*, Full Edition Volume I Book III (2009), Prepared by the Study Group on a European Civil Code and the Research Group on EC Private Law (Acquis Group), Based in part on a revised version of the Principles of European Contract Law, von Bar C. and Clive, E. (Ed.), sellier. european law publishers GmbH, Munich, p. 677.

<sup>25</sup> Nazarian (2007), pp. 137–138.

will remain the starting point, as well as the primary source, for interpretation. Since parties usually write down their common aim in a contract, this convention is natural. A clear outcome based on the interpretation of a contract's wording is, therefore, not easily dismissed.<sup>26</sup>

Having said this it is nonetheless clear that contracts today should be interpreted as a whole. This follows from, for example, decision KKO 2001:34 of the Finnish Supreme Court. In the interpretation the focus should be on all of the relevant circumstances of the case at hand and not solely on the written contract document. This convention that the law allows for the consideration of more extensive material in contract interpretation sounds perfect in theory. In practice, it is not always done. Instead many courts only consider the contract document in the interpretation.<sup>27</sup> From this point of view it may, therefore, be perceived as risky to conclude a very flexible contract. It may hand over too much power to the judge should the parties ever find themselves in a courtroom.

The parties can ensure that the principle of loyalty will be given weight in the interpretation of the contract by clearly explaining in the preamble their intention to strive for a mutual goal through loyal and close cooperation on terms that are favourable for both of them. An explicit loyalty clause can also be included in the contract stipulating that the parties will act in good faith towards each other in every respect during the term of the contract. The parties can moreover include renegotiation and/or hardship clauses in their contract in order to ensure that the agreed upon terms and the risk division in the contract can be altered through negotiations in good faith when needed. A logical next step, should none of the attempts to renegotiate lead to an acceptable solution of the problem, would be ADR in the form of mediation.<sup>28</sup> Also in mediation the goal is to find a business solution to the problem instead of focusing on who "wins" and who "loses".<sup>29</sup> In situations where parties do not trust one

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<sup>26</sup> Hemmo, M. (2008), *Sopimusoikeuden oppikirja*, Talentum, Helsinki, pp. 305–306, Saarnilehto, A. (2009), *Sopimusoikeuden perusteet*, Talentum Lakimiesliiton kustannus, Helsinki, pp. 149, 153, Ramberg, J. and Ramberg C. (2014) *Allmän avtalsrätt*, nionde upplagan, Norstedts Juridik AB, Stockholm, p. 144.

<sup>27</sup> Hemmo (2008), p. 305, Ramberg and Ramberg (2014), p. 145.

<sup>28</sup> Sund-Norrgård, P. (2013), "Omförhandling och medling – Att lösa konflikter och fortsätta samarbete", *Tidsskrift for Rettsvitenskap*, pp. 315–342 (p. 331).

<sup>29</sup> Ervasti, K. (2000), "Tuomioistuinten ulkopuolinen riitojen ratkaisu – Näkökulmia vaihtoehtoihin konfliktinratkaisumenetelmiin", *Lakimies*, pp. 1237–1263 (pp. 1250–1251), Knuts, G. (2006), *Förfarandegarantier vid domstolsanknuten medling*, Suomalainen Lakimiesyhdistys, Helsingfors, pp. 47–51.

another they will probably not include loyalty clauses or terms involving problem solving *inter partes* or through ADR in the contract.<sup>30</sup>

On the other hand, a very precise and rigid contract document that focuses on risk division gives little room for other circumstances than the wording of the contract to be considered in the interpretation. The parties can, for example, through including a *merger clause* in the contract stipulating that the written contract contains the entire agreement on the issue at hand, avoid that pre-contractual behaviours and negotiations are given weight in the interpretation. If also a *written modification clause* is included stipulating that amendments to the contract have to be in writing in order to be valid, the parties can avoid that events occurring after the conclusion of the contract is given weight in the interpretation. Such a clause greatly influences the interpretation of the contract, even though its validity is not absolute in all circumstances.<sup>31</sup> In other words the parties can, in their use of such a “classical” contracting technique, significantly hinder the impact of the principle of loyalty in the interpretation of their contract.<sup>32</sup>

In a perfect world the parties and their lawyers will cooperate in order to ascertain that the “optimal” contract – that is a well-working contract – can be concluded for every situation.

## 6. The functions and the content of the principle of loyalty

### 6.1. *The duty to inform and other duties*

The significance of the principle of loyalty varies, not only depending on the type of contract, but also depending on the phase of the contractual relationship. Loyalty and mutual trust have more prominent roles during the performance of a contract than in contract negotiations. Nevertheless, the principle of loyalty applies also in the pre-contractual phase,<sup>33</sup> and harm

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<sup>30</sup> Sund-Norrgård (2011), pp. 147–151.

<sup>31</sup> Norros, O. (2008), ”Sopimusperusteiset muotovaatimukset”, *Lakimies*, pp. 183–211 (pp. 196–199).

<sup>32</sup> Sund-Norrgård (2011), pp. 141–144, 271–279, Sund-Norrgård P. (2012), ”Lisenssisopimusten tulkinta – uudelleenarvioinnin aika?”, *Oikeustiede – Jurisprudentia XLV 2012*, Suomalaisen Lakimiesyhdistyksen Julkaisuja, Helsinki, pp. 285–333 (pp. 304–315).

<sup>33</sup> Mähönen, J. (2000a), ”Lojaliteettivelvollisuus ja tiedonantovelvollisuus”, in Ari Saarnilehto (Ed.), *Varallisuus oikeuden kantavat periaatteet*, WSOY, Helsinki, pp. 129–143 (pp. 132, 135–136),

caused by disloyal behaviour during contract negotiations can lead to liability for damages to the other party.<sup>34</sup> The principle of loyalty may direct the parties' behaviour also after the contract has been terminated.<sup>35</sup>

Based on an analysis of contract law doctrine one may conclude that the principle demands, in short, that parties to a contract also consider the interests of the other party and not just act in an egoistic and opportunistic manner. Even though it is somewhat unclear what actually follows from this requirement, it is clear that the principle's significance increases in long-term contracts between parties that are financially dependent on one another. Such contracts require mutual trust and close cooperation between the contracting parties. Good examples are franchising, agency and licensing agreements, which often also include specific contract clauses on loyalty and cooperation.<sup>36</sup>

The principle of loyalty may, for example, oblige a party to inform the other party of issues that are relevant for his performance under the contract. This obligation to inform the other party is present, not only during the on-going contractual relationship, but already in the negotiation phase before the contract is concluded.<sup>37</sup> Often a party's obligation to voluntarily inform the other party of the content of the contract is also directly based on legal rules.<sup>38</sup> One may say, that these decisions and rules express the principle of loyalty.

The principle of loyalty can moreover induce an obligation to renegotiate an existing

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Munukka (2007), p. 154.

<sup>34</sup> Nystén-Haarala (1998), pp. 121–129.

<sup>35</sup> Taxell, L. E. (1977), "Om lojalitet i avtalsförhållanden", *Defensor Legis*, pp. 148–155 (pp.151–152), Nicander (1995–96), p. 36.

<sup>36</sup> Muukkonen (1975), p. 358, Taxell (1977), p. 149, Bygglin, G. (1978), "Om franchiseavtal och upplösningsfrihet", *Oikeustiede – Jurisprudentia XI 1978*, Suomalaisen Lakimiesyhdistyksen vuosikirja, Helsinki, pp. 89–157 (pp. 137–139), Taxell, L. E. (1979), "Om avtalsetik", *Tidskrift utgiven av Juridiska Föreningen i Finland*, pp. 487–498 (p. 493), Muukkonen (1993), p. 1039, Nicander (1995–96), p. 33 Häyhä J. (1996b), "Lojaliteettiperiaate ja sopimusoppi", *Defensor Legis*, pp. 313–327 (pp. 314–315), Wilhelmsson T. (2008), *Standardavtal och oskälliga avtalsvillkor*, Talentum, Helsingfors, pp. 25–26, Sund-Norrgård (2011), pp. 55–60, Ramberg and Ramberg (2014), pp. 32–34.

<sup>37</sup> Decisions KKO 1993:130, KKO 2007:72 and KKO 2008:91 of the Finnish Supreme Court, NJA 1978 p. 147 and NJA 1990 p. 745 of the Swedish Supreme Court, Hultmark, C. (1993), *Upplyningsplikt vid ingående av avtal*, Juristförlaget Stockholm, p. 10, Runesson, E. (1996), *Rekonstruktion av ofullständiga avtal. Särskilt om köplagens reglering av risken för ökade prestationskostnader*, Juristförlaget Stockholm, pp. 129–130, Munukka (2007), p. 154.

<sup>38</sup> For example Chapter 5, Section 13 of the Consumer Protection Act and Chapter 2, Section 17 of the Code of Real Estate.

contract,<sup>39</sup> and it may require a prohibition of competition,<sup>40</sup> or a secrecy obligation.<sup>41</sup> As the principle of loyalty applies as a general contract law principle, the parties can have obligations towards each other based on the said principle that exceed the terms of the contract.<sup>42</sup> This means that, for example, the duty to renegotiate a contract can be demanded of a party also where the contract itself does *not* include a clause of this kind. In spite of this, the easiest way to ensure such an obligation is, of course, to include a well-working renegotiation clause in the contract.<sup>43</sup>

In a situation where the contract is about to be terminated one cannot, for example, assume that a secrecy obligation for trade secrets is perceived as any less important than it was during the on-going contractual phase. On the other hand some information duties may be significantly less important at this stage.<sup>44</sup> When the contract is about to end the principle of loyalty may also lead to the conclusion that a contract cannot be terminated without a termination period of a certain length in order to make it possible for the other party to “recoup” and cut his losses. Or it might lead to the conclusion that a valid reason is needed for termination – especially if the termination period in the contract is very short – even though freedom to terminate a contract is the starting point in Nordic contract law.<sup>45</sup>

## *6.2. Filling gaps and modifying terms in the contract*

The principle of loyalty can fill gaps in the contract, and its application may even lead to a modification of express terms in a contract.<sup>46</sup>

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<sup>39</sup> Grönfors (1995), p. 39, Nystén-Haarala (1998), p. 35.

<sup>40</sup> Nicander (1995–96), p. 32, Holm (2004), pp. 1–3.

<sup>41</sup> Ramberg and Ramberg (2014), p. 34.

<sup>42</sup> Häyhä (1996b), p. 314.

<sup>43</sup> Pöyhönen (1988), p. 374, Grönfors (1995), pp. 39, 61–67, Taxell, L. E. (1997), *Avtalsrätt. Bakgrund, Sammanfattning, Utblick*, Juristförlaget Stockholm, p. 52, Sund-Norrgård (2013), pp. 328–329.

<sup>44</sup> Nicander (1995–96), p. 36.

<sup>45</sup> Bygglin (1978), pp. 137–140, Hemmo, M. (1996), ”Irtisanomisvapaus ja pitkäkestoiset liikesopimukset”, *Defensor Legis*, pp. 328–346 (pp. 330–333), Runesson 1996, p. 360, Hemmo, M. (2003), *Sopimusoikeus II*, Talentum, Helsinki, pp. 385–390, Halila, H. and Hemmo, M. (2008), *Sopimustyyppit*, 2. uudistettu painos, Talentum Media Oy, Helsinki, pp. 276–277, Sund-Norrgård (2011) pp. 193–205.

<sup>46</sup> Taxell (1972), pp. 74–75, Pöyhönen (1988), pp. 64–66, Nicander (1995–96), p. 37, Häyhä, J. (1996a), *Sopimus, laki ja vakuustointiminta*, Suomalainen Lakimiesyhdistys, Helsinki, pp. 21–22, 221,

When one has to decide what is to be considered loyal the idea, according to the Finnish scholar Juha Häyhä, is to start from what in a similar situation is perceived as customary, and therefore predictable.<sup>47</sup> Häyhä speaks about the mechanism of tradition. The mechanism of tradition looks backwards. The interaction creates expectations to civil law actors, and for example recurrence can substitute a norm.<sup>48</sup>

As a starting point the contract is not born in an “empty space”. On the contrary, there are circumstances and events around the contract, which are relevant from the legal point of view. This means that the foundation of legitimate expectations is not based only on the contract, but the contract is based on legitimate expectations too. In other words, the principle of loyalty can fill the space around the (written) contract when the parties’ rights and obligations are to be determined. It also means that there are legitimate expectations already *before* the contract is concluded.<sup>49</sup> Examples of this can be found in the practice of the Finnish Supreme Court,<sup>50</sup> and also in Finnish law. For example according to Section 9.1 of the Insurance Contracts Act an insurance contract is considered to be in force to the effect understood by the policyholder on the basis of the information received, in a situation where the insurer or his representative has failed to provide the necessary information or has given incorrect information to the policyholder, when marketing the insurance.

In a situation where the parties expect that everything will “go as usual”, they might not conclude a written contract at all.<sup>51</sup> This can be so in a situation when there has been plenty of previous interaction between the parties, which lead them to believe that things will go on in the same way also in the future. When certain events are repeated often enough, they create expectations. Commercial and other customs have the same effect.

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Häyhä (1996b), p. 319, Annola, V. (2003), *Sopimuksen dynaamisuus: Talousoikeudellinen rakennetutkimus sopimuksen täydentymisestä ja täydentymisen ohjaamisesta*, Turun yliopiston oikeustieteellisen tiedekunnan julkaisuja, Turku, pp. 31, 85–89, 199, Ramberg and Ramberg (2014), pp. 32–33.

<sup>47</sup> Häyhä (1996a), pp. 220–225.

<sup>48</sup> Häyhä, J. (2000), *Jälleenvakuutus sopimuksena*, Helsingin yliopiston oikeustieteellinen tiedekunta Helsinki, pp. 19, 122–124, 269–273.

<sup>49</sup> Häyhä (1996b), pp. 319, 322–323, Häyhä, J. (1998), ”Oikeusperiaatteet ja sopimuksen purkaminen”, in *Juhlajulkaisu Kaarlo Tuori*, Helsingin yliopiston julkisoikeuden laitoksen julkaisuja, Helsinki, pp. 115–142.

<sup>50</sup> KKO 1984 II 181.

<sup>51</sup> Macaulay, S. (1963), ”Non-contractual Relations in Business: A Preliminary Study”, *American Sociological Review*, pp. 1–19 (pp. 12–14).

If a party's trust is based on expectations that follow from interaction between contractual parties or from business customs, the principle of loyalty offers a method for creating flexibility in contract drafting. Since the content of a contract can often be established by these expectations, the principle of loyalty means that it is not always necessary to conclude an accurate contract without gaps. In fact, if one can trust how things will go on, there might be no need to conclude a contract at all.

The principle of loyalty can be seen as the legal basis for legal protection based on legitimate expectations that arise from outside the contract. The principle of loyalty thereby fulfils the "empty space" around the contract and makes contracting more flexible. And also in the interpretation of a contract, relevance can be given to such expectations, which are based on the reality surrounding the contract.<sup>52</sup> Through such an interpretation, which is connected to the principle of loyalty, it is possible to achieve more flexibility.

## 7. Concluding remarks

A flexible contract, which is less focused on predictability and risk allocation, can be perceived by the parties as riskier than a more rigid one. Therefore, flexible contracts should be concluded in situations where they actually work for the parties; that is when the parties, for example, are about to conclude a contract involving long-term close cooperation towards a common goal. In such a situation the parties will probably find a flexible contract more useful than a very rigid one. This follows from the fact that circumstances – as well as the parties' needs – are likely to change during the term of the agreement, wherefore also their contract must be designed to change along with such changes. Otherwise the contract will not be perceived as a well-working one.

We also believe that norms can be helpful in the contract drafting process. For example in a situation, where the parties are about to enter into a long-term cooperation, the knowledge of the existence of the principle of loyalty might support their choice to conclude a flexible contract. This follows from the fact that the principle of loyalty can help clarifying for the parties the behaviour that can be expected of them, as well as what they can expect from

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<sup>52</sup> Decision KKO 1992:50 of the Finnish Supreme Court, Häyhä (1998), p. 137.

others. This is essentially a form of “business sense” consisting of the right to expect that the other party will act in a way perceived as “normal” for the type of contract in question within the said trade. Such legitimate expectations facilitates trust, and trust makes rigid contracts covering “everything” less important, since it is not necessary to safeguard against the other party’s opportunistic behaviour. In a sense the existence of the principle of loyalty therefore makes flexibility in contracts easier.

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# **Trust as Intellectual Capital in Pursuing Flexibility in Business Contracting**

TAINA SAVOLAINEN,<sup>1</sup> MIRJAMI IKONEN<sup>2</sup>

This paper looks contracting from an intellectual capital perspective, and specifically from the trust point of view. The paper discusses the role of trust as intangible asset in flexible contracting. The paper looks both trust and contracting from relational and processual perspectives meaning a collaborative activity between partners and partnering organizations in contracting processes. The purpose of the paper is to increase understanding of the role and nature of trust as intangible resource for contract management in pursuing flexibility thinking in contracts. Trust is seen as a leadership skill<sup>3</sup> which leaders may use in influencing contract management specifically when negotiating flexible contracts. The proactive law approach provides potential in approaches, theories, and applications to discuss and integrate the organization behavior and leadership perspectives with contracting. It is commonly the management at different levels that is involved in contracting processes in organizations. Contracting involves behavioral skills such as communication for trust building. Trust is a relational asset forming a foundation for collaborative efforts between contracting parties. Therefore, examining the role, antecedents, and consequences of trust as a powerful element in business contracting is well grounded. The paper aims to broaden the scope of discussion about new approaches and practices needed and emerging in the changing field of contracting. Moreover, the purpose is to discuss flexibility in contracting in the view of how trust may facilitate and advance flexibility. Originality of the paper is based on the two main points: examining the role of trust in contracting as a relational, intellectual capital, and bringing a scarcely studied processual view into discussion about trust development and flexibility in contract management. The paper advocates the idea of seeking a balance between trust and contracts, i.e., control vs. freedom and flexibility.

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<sup>1</sup> Professor (Management and Leadership), University of Eastern Finland.

<sup>2</sup> University Lecturer, PhD, University of Eastern Finland.

<sup>3</sup> Savolainen, T. (2010) Role of trust in managing customer focus: Multilevel theoretical and empirical issues. In *Proceedings of the 5th EIASM Workshop on Trust within and between organizations, Madrid, Spain*.

## 1. Introduction

The study looks business contracting from organizational and managerial research perspectives, more specifically, from the trust point of view. We discuss the nature of trust and business contracting and how trust in flexible contracting comes into scene. The paper pursues initiating opportunities of examining the topic as multidisciplinary and international issue, and in research collaboration within the network that exists and/or may be further developed. A new direction, unexplored so far, is to broaden the scope into empirical research on real life operations and changing contexts in which trust and contracting are embedded currently. Therefore, innovative and creative views and ways of studying the relationship between trust and flexible contracting are needed to increase scientific knowledge of the topic. The paper advocates the idea of pursuing a balance between trust and contracts, i.e., control vs. freedom and flexibility, in other words, decreasing a tension, that may exist between a ‘controlling role’ of contracts, and a flexible, relationally ‘balancing role’ of trust.

The paper focuses on contractual relations which have raised more attention in ever more complex business relationships networks within and between organizations. Trust is brought into discussion as influential force for co-operation and co-creation in contracting, and for a more effective collaborative atmosphere within organizations and beyond. Despite of the contract practices that may have a starting point in suspicions (distrust) there is also space and freedom for the parties to decide how to draft contracts in the practices of contracting. In this process managerial leadership plays a role and trust building forms a useful skill. First, the article provides a literature review of trust and the nature of trust in the contracting context; second, a discussion is made from the contracting point of view, and third, ideas are presented of the integration of these two perspectives in the view of balance and flexibility.

## 2. Concept of trust

Interpersonal trust is reciprocal in nature, and thus *relational* deriving from repeated interactions over time between trustor and trustee. Information available to the trustor from *within the relationship itself* forms the basis of trust between parties. Reliability and

dependability in previous interactions with the trustor give rise to positive expectations about the trustee's intentions.

### *2.1 Trust as intellectual, intangible capital*

Trust has become an essential intangible asset in organizations and leadership. Trust promotes social order and cooperation. It is a resource that creates vitality and enables innovativeness for organizations.<sup>4</sup> Trust is embedded in the known theoretical classification of intellectual capital as human, structural and relational capital<sup>5</sup>. Trust building is seen as human intellectual skill in leadership.<sup>6</sup> It is seen as intangible asset within structural capital; and as relational in customer interaction and inter-organizational relationships.<sup>7</sup> Trust is a key element in cooperation and communication in organizations contributing to knowledge sharing in different types of relationships between actors.<sup>8</sup>

Contracting processes are generally consisted of a number of human beings from multiple and different constituencies, backgrounds and cultures. In these contexts, differing manners likely exist and ways of communication and professional jargons as well as amenity and willingness to trust differ; moreover, perceptions and understanding of the meaning and even the role of trust in organizational contracting contexts vary. It is worth noticing that, in networks, intra-organizational processes such as managerial leadership could support the development of atmosphere, communication, openness and mutual understanding,<sup>9</sup> e.g., willingness to compromise in the negotiations of different exchanges and transactions

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<sup>4</sup> Savolainen, T. Lopez-Fresno, P. (2013) Trust as Intangible Asset - Enabling Intellectual Capital Development by Leadership for Vitality and Innovativeness. *The Electronic Journal of Knowledge Management* 11, (3), 244-255.

<sup>5</sup> Edvinsson, Leif and Malone, Michael (1997) *Intellectual Capital: Realising Your Company's True Value by Finding its Hidden Roots*. New York, NY: Harper Collins.

<sup>6</sup> Savolainen, Taina (2011) Luottamusjohtajuus inhimillisen pääoman uudistamisessa. (Leadership by trust in Renewing intellectual capital) In Puusa, A. and H. Reijonen (eds.): *Aineeton pääoma organisaation voimavarana*, UNIPress, 117-141.

<sup>7</sup> Edvinsson & Malone, 1997; Nahapiet, J. Ghoshal, S. (1998) Social capital, intellectual capital, and the organizational advantage. *Academy of Management Review* 23, (2), 242-265; Savolainen, 2011.

<sup>8</sup> Savolainen et al., 2014; Ikonen, Mirjami and Savolainen, Taina (2011) Renewing Human Intellectual Capital by Building Trust in Intra-organizational Relationships. In *Proceedings of the European Conference on Management, Leadership and Governance, Sophie-Antipolis, France*

<sup>9</sup> Savolainen, T. (2010) Role of trust in managing customer focus: Multilevel theoretical and empirical issues. In *Proceedings of the 5th EIASM Workshop on Trust within and between organizations, Madrid, Spain*.

requiring contract making. Negotiated agreements provide the basis for business, government and inter-organizational and -national relations.<sup>10</sup>

These questions show the complexity of the area of contract management from the social, cultural and organizational point of view. Power relations make trust more complex and fragile in relationships. Moreover, cultural differences appear; they are manifested in varying degrees of power distance, uncertainty tolerance, and collectivism.<sup>11</sup> Therefore, our aim is to stretch beyond a mere excellent contracting suggesting that there are issues that matter in successful contract management from which the proactive law approach could benefit.

Trust is approached mainly as a relational concept and has been defined and categorized in numerous ways. The study takes a closer look at the concept of trust in business contracting context. While many definitions exist the concept remains without a generally accepted definition.<sup>12</sup> The *relational definition* of trust, applicable to the perspective of this study, is developed by Mayer et al.: “The willingness of a party to be vulnerable to the actions of another party based on the expectation that the other will perform a particular action important to the trustor, irrespective of the ability to monitor/control that other party.”<sup>13</sup>

This definition of trust by Mayer et al. is applicable to relationships in an organizational context, i.e., in a relationship between a trustor and a trustee who is perceived to act and react with volition toward the trustor. Making oneself vulnerable is taking risk and implies that there is something of importance to be lost. Trust is not taking risk per se, but rather it is a willingness to take risk.<sup>14</sup>

Trust is defined above from a relational perspective which thus links it with relational contracting. Trust is paradoxical phenomenon in the modern society that is characterized by increasing uncertainty, complexity and risk. Broadly defining trust in exchange relationships,

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<sup>10</sup> E.g. structural, affective and contractual factors have been studied by Mislin et al., 2011.

<sup>11</sup> Hofstede, Gert. (1997) *Cultures and Organizations: Software of the Mind*. McGraw-Hill USA; cf. Trompenaars, Fons and Hamden-Turner, Charles. (1997) *Riding the Waves of Culture: Understanding Cultural Diversity in Business*. London: Nicholas Brealey Publishing Ltd.

<sup>12</sup> McEvily, B. Perrone, V. Zaheer, A. (2003) Trust as an organizing principle. *Organization Science* 14, (1), 92-103; p. 101.

<sup>13</sup> Mayer, R. Davis, J. Schoorman, D. (1995) An integrative model of organizational trust. *Academy of Management Review* 20, (3), 709-734.p. 712.

<sup>14</sup> Mayer, R. Davis, J. Schoorman, D. (1995) An integrative model of organizational trust. *Academy of Management Review* 20, (3), 709-734; p. 712.

and also related to contractual relations in intra- and inter-organizational relationships, the following definition by Hosmer is applicable: “The reliance by one person, group, or firm upon a voluntarily accepted duty on the part of another person, group, or firm to recognize and protect the rights and interests of all others engaged in a joint endeavor or economic exchange.”<sup>15</sup>

Trust-based relationships refer to the situation where, instead of the intent to pursue and gain merely personal benefits, willingness to collaborate and compromise exist between parties. Paradoxically, trust involves uncertainty, complexity and risk in the current business environment.<sup>16</sup> Contract making is often multipart decision making effort within dyads or on a group level. While risk taking is at the core of trust,<sup>17</sup> trust forms a source of security. Therefore, it seems clear that the more a person trusts another’s future actions, the more securely and with more confidence the said person will take part in the activities of the object of trust.<sup>18</sup> Here trust is seen as a mechanism that enables organizational actors, such as managers, to create open organizational culture which, in turn, affects the sharing of information and knowledge. Information sharing facilitates problem solving and adaptation. Contracting actors (parties) are willing to share private information with one another including short and long-term plans and goals. As a result mutual trust develops and increases and willingness to collaborate, consequently.<sup>19</sup> Thus, trust reduces uncertainty and vulnerability in the relationships between inter- and intra-organizational actors.<sup>20</sup> In other words, a tendency to making contracts by lawyers for avoiding conflicts or disputes in courts represents a kind of mistrust- or distrust-based approach to contracting. A trust-based approach instead favors compromising and lowering risk preventively in the negotiation process of contracts.

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<sup>15</sup> Hosmer, L.T. (1995) Trust: The connecting link between organizational theory and philosophical ethics. *Academy of Management Review* 20, (3), p. 381.

<sup>16</sup> Bachmann, Reinhard (2000) Conclusion: Trust – Conceptual Aspects of a Complex Phenomonon. In Lane, C. and R. Bachmann (eds.): *Trust Within and Between Organizations*. Oxford: Oxford University Press.

<sup>17</sup> Mayer et al. (1995).

<sup>18</sup> Das, T. Teng, P. (1998) Between trust and control: developing confidence in partner cooperation in alliances. *Academy of Management Review* 23, (3), 491-512.  
1998, p. 494.

<sup>19</sup> Poppo, L. Zenger, T. (2002) Do Formal Contracts and Relational Governance Function as Substitutes or Complements? *Strategic Management Journal* 23, 707-725.

<sup>20</sup> Möllering, G. Bachmann, R. Lee, S. (2004) Understanding organizational trust – foundations, constellations, and issues of operationalisation. *Journal of Managerial Psychology* 19, (6), 556-570.



When companies use contracts as means of cooperation and communication in business it may produce a competitive advantage for businesses. Contracts provide also means of control and change. Contracts play a proactive role, in other words, to prevent disputes and to achieve business goals in turbulent organizational changes. The proactive approach would benefit businesses for contracting practices and business competitiveness, accordingly.

## 2.2 Trust in contracting

Pertaining to contracting, a traditionally held view is that contracts in general refer to lack of trust or distrust. Recently, scholars have pointed out that the relationship between trust and contracts depend on when, why and how contracts are used. Weibel et al.<sup>21</sup>, Möllering<sup>22</sup> and Klein Woolthuis et al.<sup>23</sup> suggest that trust and contract can be both complementary and substitutive.<sup>24</sup> As contracts tend to be more or less incomplete trust is needed as an asset and skill to pursue collaboration and balance emerging or existing conflicts or disputes. Trust may play the role of moderator and facilitate flexibility for achieving the expected outcome, for instance, trust may enhance communication and sharing information.<sup>25</sup> Trust is therefore involved as an essential part of contractual arrangements, i.e., a process and relations.

Organizational leadership and culture have an influence on the success of contracting processes. Different types of contracts need different form of trust.<sup>26</sup> Higher level of trust makes decision making more efficient by simplifying the processes of seeking and interpreting information.<sup>27</sup> According to Barry and Oliver,<sup>28</sup> the heading “post-negotiation

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<sup>21</sup> Weibel, A. Madhok, A. Mellewigt, T. (2007) Trust and formal contracts in interorganizational relationships - substitutes and complements. *Managerial and Decision Economics* 28, (8), 833-47.

<sup>22</sup> Möllering, Guido (2006) Trust: Reason, Routine, Reflexivity. Oxford: Elsevier. p. 66.

<sup>23</sup> Klein Woolthuis, K., Hillebrand, B. Nooteboom, B. (2005) Trust, Contract and Relationship Development. *Organization Studies* 26, (6), 813–840.

<sup>24</sup> On complementarity see also, e.g., Poppo & Zenger (2002).

<sup>25</sup> Vlaar, Paul (2013) Trust and contracts: together forever, never apart? In Bachmann, R. and A. Zaheer (eds.): *Handbook of Advances in Trust Research*. Edward Elgar, 29-54.

<sup>26</sup> Malhotra, D. Murnighan, J.K. (2002) The effects of contracts on interpersonal trust. *Administrative Science Quarterly* 47, (3), 534-559; see also Möllering, Guido (2006) Trust: Reason, Routine, Reflexivity. Oxford: Elsevier.

<sup>27</sup> McEvily, B. Perrone, V. Zaheer, A. (2003) Trust as an organizing principle. *Organization Science* 14, (1), 92-103; p. 93.

<sup>28</sup> Barry, B. Oliver, R. (1996) Affect in Dyadic Negotiation: A Model and Propositions. *Organizational Behavior and Human Decision Processes* 67, (2), 127-143.

affect” includes the concept of trust. Mislin et al.<sup>29</sup> found out that trust is built by the talks consisting of the negotiation process. Therefore, in sustaining competitiveness through excellent contracting trust-based relationships enable negotiations which may result in prosperous outcomes. Processes of trust are quite scarcely studied so far, in other words, how trust develops, is built and re-built. An important issue is the process by which trust evolves.<sup>30</sup>

Therefore, a literature review of trust and contracting in empirical settings as well as conceptual studies could shed more light into the role trust plays in contracting and into the emerging issue of flexibility, more specifically. To mention a few studies in prior research, e.g. Lane and Bachmann<sup>31</sup> have described contract law as an important institutional framework for trust-based interaction. Möllering<sup>32</sup> depicts that assurance and orientation gained from the existence of sanctions promotes trust. Not only dyadic relationships but also industrial, organizational and network level relations are examined in the literature. For example, legal regulation has an effect on the development of trust in the workplace.<sup>33</sup> Contractual trust can develop into organizational trust.<sup>34</sup> As Chenhall and Langfield-Smith<sup>35</sup> have stated, interpersonal trust rarely arises spontaneously in business organizations but trust is fostered through formal contracts. These researchers have also produced empirical evidence on the mechanistic control inhibiting the development of trust. The literature review leads to specific expectations on peculiar mechanisms needed for flexible contracting.<sup>36</sup> Trust is posed as a prerequisite for knowledge sharing in addition to traditional modes of

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<sup>29</sup> Mislin et al. (2011) Mislin, A. Camoagna, R. Bottom, W. (2011) After the deal: Talk, trust and the implementation of negotiated agreements. *Organizational Behavior and Human Decision Processes*, 115, 55-68.

<sup>30</sup> Mayer et al. (1995); Savolainen, Taina and Ikonen, Mirjami (2015) Emergence of trust development process - a qualitative study in the team context. In S. Jagd and L. Fuglsang (eds.) *Studying Trust as Process within and between Organizations*.

<sup>31</sup> Lane, C. Bachmann, R. (1996) The social constitution of trust: Supplier relations in Britain and Germany. *Organization Studies* 17, 365-395.

<sup>32</sup> Möllering, Guido (2006) *Trust: Reason, Routine, Reflexivity*. Oxford: Elsevier.

<sup>33</sup> Streeck, Wolfgang (1992) *Social Institutions and Economic Performance: Studies of Industrial Relations in Advanced Capitalistic Countries*. London: Sage.

<sup>34</sup> Chenhall, R. H. Langfield-Smith, K. (2003) Performance Measurement and Reward Systems, Trust, and Strategic Change. *Journal of Management Accounting Research*, 15, (1), 117-143.

<sup>35</sup> Ibid.

<sup>36</sup> E.g. Jeffries, F.L. Reed, R. (2000) Trust and adaptation in relational contracting. *Academy of Management Review* 25, (4), 873-882.

governance such as formal control mechanisms. Moreover, understanding the roles and dynamics of contracts and trust is crucial for inter-organizational collaboration.<sup>37</sup>

We suggest a *processual approach* as an alternative for the traditional approach. In a process view, trust in contracting is seen as a process, where exchange or negotiation between two parties is occurring during the whole process of relationships between parties. Both parties have expectations related to their current and future needs and values. Trust is embedded in a series of episodes, in which information is exchanged in order to determine how to proceed in contracting. The process of interpersonal, dyadic trust development appears more complex and uneven than the prior research has suggested.<sup>38</sup> Trust development in contracting may also easily turn into lack of trust or distrust instead of a positive development cycle of trust.<sup>39</sup>

### 2.3 Role of trust after the deal

The literature on negotiation has not adequately captured the dynamics in negotiation.<sup>40</sup> Reciprocity in negotiations increases the understanding of how actors (parties) behave. Trust is also highly dynamic and contextual in nature. Regarding both trust and negotiation as dynamic phenomena leads to yet unexplored process perspective. Trust in contracting is seen as paradoxical in nature, as the coexistence of trust and distrust may produce turns and shifts within relationships between people involved. Rebuilding trust depends on the extent and motives of trust breach: In contracting, misunderstandings may unintentionally occur, and from the perspective of trust development, misunderstandings should be settled down as early as possible. In the process of contracting, a clear articulation of the periods of considering and rethinking is important in order to avoid misunderstanding and trust diminishing.

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<sup>37</sup> Blomqvist, K. Hurmelinna, P. Seppänen, R. (2005) Playing the collaboration game right - balancing trust and contracting. *Technovation* 25, 497-504.

<sup>38</sup> Ikonen, Mirjami (2013) *Trust Development and Dynamics at Dyadic Level. A Narrative Approach to Studying Processes of Interpersonal Trust in Leader-Follower Relationships*. Joensuu: University of Eastern Finland, Business School. (Diss.); Savolainen, Taina and Ikonen, Mirjami (2015) Emergence of trust development process - a qualitative study in the team context. In S. Jagd and L. Fuglsang (eds.) *Studying Trust as Process within and between Organizations (submitted manuscript, forthcoming)*.

<sup>39</sup> Cf. Ikonen, M. (2013).

<sup>40</sup> Gelfand, M.J. Smith Major, V. Raver, J.L. Nishii, L.H. (2006) Negotiating relationally: The dynamics of the relational self in negotiations. *Academy of Management Review* 31, (2), 427-451; p. 428.

Recently, the need for trust in negotiation is discussed by Lewicki and Polin.<sup>41</sup> In the current paper, negotiation is also defined as a process, *negotiating*, as a part of a larger process of contracting which includes all the organizing and coordinating activities within and between organizations, e.g. making sense of one's partner and the environment.<sup>42</sup>

### 3. Leadership role in contract management

The discussion in the paper aims to advocate *the idea of seeking a balance between trust and contracting (a tension between control and freedom and/or flexibility)*. Leadership plays a role in this and, thus, the perspective of managerial leadership is brought into discussion. Moreover, the nature of trust needs to be discussed in the context of contracting. Leaders act in daily processes of organizations and use the means of influencing people by building trust and other managerial skills. Leadership is defined in essence as exerting influence on a group of people or an individual for achieving common goals in interaction with people.<sup>43</sup>

The management is commonly involved in contracting processes in organizations at different levels and forms. Following the definition of influencing and interaction, contracting behavior involves interactive and influential leadership activity. Leaders key task in general is to communicate, advocate, and achieve common goals through people to achieve expected and mutually satisfying results between individuals, parties, and within groups. For this trust forms a foundation for willingness to mutual collaboration. Interaction and time with open communication are the key building blocks for functioning relationships.<sup>44</sup>

Showing of trustworthiness, i.e., competence, benevolence and integrity, become more important for leaders. Communication and negotiation skills are essential for collaborative

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<sup>41</sup> Lewicki, Roy and Polin, B. (2013) The role of trust in negotiation processes. In R. Bachmann and Zaheer, A. (eds.): *Handbook of Advances in Trust Research*. Edward Elgar, 29-54.

<sup>42</sup> Vlaar, Paul (2013) Trust and contracts: together forever, never apart? In Bachmann, R. and A. Zaheer (eds.): *Handbook of Advances in Trust Research*. Edward Elgar, 29-54.

<sup>43</sup> Cf. Yukl, Gary (2010) *Leadership in Organizations*. 10<sup>th</sup> ed. Prentice Hall.; Northouse, Peter (2004) *Leadership. Theory and practice*. 3<sup>rd</sup> ed. Thousand Oaks, CA: Sage Publications, Inc.

<sup>44</sup> Savolainen, Taina (2008) Leadership and trust as influential forces for contract management. In *Publications in Law/21*. University of Joensuu: University Printing House, 119-129.

and trustful working atmosphere and collaborative activity.<sup>45</sup> Leaders have impact on the openness of culture, and atmosphere that encourages free flow of ideas, knowledge and their sharing. Leadership and organizational culture characterized by freedom and openness also best foster and support collaborative inter-organizational relationships needed for productive contracting.

### 3.1 Relational view into leadership, trust and contracting

In general, the relationship as such involves relational processes or relatedness. Thus, a relationship exists where there is an element of interdependence and some type of interaction<sup>46</sup>. Leaders are responsible both in vertical and horizontal relationships in intra- and inter-organizational relationships. As Bachmann<sup>47</sup> notes, trust does not occur spontaneously and automatically but is deliberately created and shaped, which justifies studying how trust develops and searching for a better understanding of effective trust-building as a process.<sup>48</sup>

Pertaining to leadership perspective, there are two theoretical frameworks to studying trust development in contracting relationships, namely Leader-Member Exchange Theory (in intra-organizational leader-follower relationships) and the Agent Theory (dyadic contractual vertical relationships). Leader-Member Exchange Theory (LMX) describes a leadership role and behavior in internal organizational relationships. It can be applied in this study, as the perspective of contractual relationships is in focus and dyadic and group level activity comes into question.<sup>49</sup> The LMX-theory looks mainly a dyadic level<sup>50</sup>, as stated above with the

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<sup>45</sup> Savolainen, T. Lopez-Fresno, P. Ikonen, M. (2014) Trust-Communication Dyad in Inter-Personal Work Relationships - Dynamics of Trust Deterioration and Breach. *The Electronic Journal of Knowledge Management*.

<sup>46</sup> Atkinson, Sally. (2004) Senior management relationships and trust: an exploratory study. *Journal of Managerial Psychology* 19, (6), 571-587.

<sup>47</sup> Bachmann, R. (2011) At the crossroads: Future directions in trust research. *Journal of Trust Research* 1, (2), 203-213.

<sup>48</sup> Savolainen, T. Lopez-Fresno, P. Ikonen, M. (2014) Trust-Communication Dyad in Inter-Personal Work Relationships - Dynamics of Trust Deterioration and Breach. *The Electronic Journal of Knowledge Management*.

<sup>49</sup> Brower, H.H., Schoorman, F.D. Tan, H.H. (2000) A Model of Relational Leadership: The Integration of Trust and Leader-Member Exchange. *Leadership Quarterly* 11, (2), 227-250.

definition of trust. Trust makes cooperation desirable; and leadership support enables individuals to convert that desire into action in work relationships which may also be multipart. Both trust and leadership are necessary, but in combination they create conditions for integrating the disparate thinking and actions of dispersed people which commonly characterizes contracting circumstances.

In the most advanced stage of development reaching a partnership/company stage, specific (and dyadic) relationships extend to groups and networks – called as ‘Team-Making Competence Network’<sup>51</sup>. This is what applies well to contracting contexts. Network relationships have been examined from the interaction/ network perspective for a couple of decades (called as B2B and IMP - Industrial purchasing and marketing). The approach comprises three dimensions: technical, social and economic. Trust and contracts are seen as linked in the IMP approach since they are even defined as mutually exclusive. If high level of trust exists, official rules and contracts are not perceived necessary.<sup>52</sup>

*Contract is intangible resource* referring to *intellectual property* that is co-created with contracting parties. Successful projects and outcomes are delivered and achieved in environments where high levels of trust exists among the collaborators, and in which they may openly share their problems, concerns, and opinions without suspicions and fear of punishments. This makes trust and contracting support each other and business competitiveness, eventually. Trust and trust building form intangible asset and skill, utilizable at organizational, group and individual levels as antecedent and foundation for contractual relations and needed in exchange arrangements when contracts are made and implemented.

As advantages of trust are many, cost effectiveness may be realized as one of the most important gains from the competitiveness point of you; making deals and realizing them become less risky and complex if parties trust each other. Moreover, conflicts can be solved more constructively in relational, often face to-face, interaction. In conflict situations, acceptance is achieved to decisions even unpleasant if the motives and good intentions of a

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<sup>50</sup> Graen, G.B. Uhl-Bien, M. (1995) Relationship-based approach to leadership: Development of leader-member exchange (LMX) theory of leadership over 25 years: Applying a multi-level multi-domain perspective. *Leadership Quarterly*, 219-247.

<sup>51</sup> Ibid.

<sup>52</sup> Huemer, L. (2004) Activating trust: the redefinition of roles and relationships in an international construction project. *International Marketing Review* 21, (2), 187-201.

party or authority can be trusted. Rebuilding of trust occurring, e.g., as a consequence of malpractices is an important issue of business contracting management in inter-organizational relations and networks. Yet, the issue has been scarcely discussed and examined so far.

### 3.2. *Control, trust and flexibility*

According to agent theory contracting partners usually have different expectations of the advantages of contracting and the theory suggests developing control mechanisms to manage the processes. The current paper focuses on the tension between control and flexibility. Contracts are relational governance arrangements in economic exchange based on collaborative actions within and between organizations. Inter-organizational exchanges are typically repeated exchanges that are embedded in social relationships. Governance is value-based and agreed-on process occurring in social relationships. Through the social processes, relational governance play a role in mitigating the exchange hazards targeted by formal contracts.<sup>53</sup> As contracts can be seen as a form for collaboration, trust functions as both foundational and complementary mechanism.<sup>54</sup> In reality, contracts tend to be incomplete and trust is needed for initiating and developing collaboration and achieving the expected outcome. Thus, trust becomes a necessary part of a contracting process. At least in the situations where a contract cannot be defined explicitly, the expectations of the actions of the other party are communicated, clarified and expressed through trust.<sup>55</sup>

### 3.3 *Balancing trust and control*

This paper suggests that the appropriate solution in tensions between control and trust may be reached through combining and balancing the two. Control alone can be very expensive, but so can mere trusting. Control plays commonly a role if the level of trust is low. Trust, in turn, is related to and, in fact, viewed as a part of control but also a substitute for hierarchical

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<sup>53</sup> Poppo, L. Zenger, T. (2002) Do Formal Contracts and Relational Governance Function as Substitutes or Complements? *Strategic Management Journal* 23, 707-725.

<sup>54</sup> Cf. Bradach, J. and Eccles, R (1989) Price, authority and trust: from ideal types to plural forms. *Annual Review of Sociology* 15, 97-118.

<sup>55</sup> Dasgupta, Partha (1988) Trust as a Commodity. In Gambetta, D. (ed.): *Trust: Making and Breaking Cooperative Relations*. Department of Sociology, University of Oxford, 49-72

control.<sup>56</sup> If one trusts another, there is less need to control the other's behavior and activities. When suspicions decrease or do not arise, flexibility may increase. Thus, the appropriate result might be reached through balancing trust and control. This may have implications to the entire process of business contracting, more specifically to flexibility that facilitates adaptation to unforeseeable issues and events.<sup>57</sup>

#### 4. Conclusions

Erosion of trust in society and business life is evident due to major changes at multiple levels. In contracting, on the other hand, flexibility is needed, as tight regulations and complex contracts increase bureaucracy. In the global scale, increasing flexibility in contractual relations, virtualization of organizational forms and more complex intra- and inter-organizational relationships (including diversity and e-relationships) have made networks less easy to manage for exchange arrangements.<sup>58</sup> Thus, challenges and contradictions exist and solutions will be needed.

In conclusion, the discussion imply that, in contracting processes trust and trust building form and influential intangible asset and skill for more effective contract management where leadership skills need to be developed. In business contracting, trust building and showing trustworthiness cannot be overestimated in the current business environments making strong requests of cooperative abilities in intra- and inter-organizational practices. Trust has become one of the key resources in collaborative exchange relationships within and between organizations. It, thus, deserves to be studied and understood as competitive asset and advantage in organizations and networks.<sup>59</sup>

This paper highlights the importance of raising the level of awareness of the role trust, trust building and leadership skills play in the processes of contracting in organizations and

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<sup>56</sup> Costa, A.C. Bijlsma-Frankema, K. (2007) Trust and Control Interrelations. New perspectives on the Trust-Control Nexus. *Group & Organization Management* 32, 392-406.

<sup>57</sup> Poppo, L. and Zenger, T. (2002).

<sup>58</sup> E.g. Creed, W.E. Miles, R.E. (1996) Trust in organizations, a conceptual framework. In R. Kramer and T. Tyler (eds.): *Trust in Organizations: Frontiers of Theory and Research*. SAGE, 16-39.

<sup>59</sup> Savolainen, Taina (2011) Luottamusjohtajuus inhimillisen pääoman uudistamisessa. (Leadership by trust in Renewing intellectual capital) In Puusa, A. and H. Reijonen (eds.): *Aineeton pääoma organisaation voimavarana*, UNIPress, 117-141.



networks. The discussion is crystallized in the suggestion of a balancing view to ease tensions between trust and control for pursuing flexibility in the processes of business contracting. Therefore, the main point for further research is concluded in the aim to discover empirically how trust develops and is built and re-built, and how it facilitates and makes balance between trust and control for flexibility in business contracting. The view of process studies in trust was also brought into discussion of flexible business contracting. As scarcely discussed and examined so far the process perspective would deserve more attention in further empirical research.

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Yukl, Gary (2010) *Leadership in Organizations*. 10<sup>th</sup> ed. Prentice Hall.

## **Flexibility in Assignment of Contractual Rights:**

### **Assignment of Account Receivables**

LINGYUN GAO<sup>1</sup>

One significant aspect of contract flexibility is the ability of contracting parties to transfer their rights and duties, through the doctrines of assignment and delegation, which reduces risks and advances efficiency. The assignment of account receivables may be the most commonplace, and most important, example of this type of contract flexibility. As transactions become more global, however, both the laws and the practices surrounding assignment of account receivables become more complex and national laws differ concerning the assignment of these intangible rights and the regulations of financial intermediaries who carry out the transaction. More and more, businesses must understand the challenges and opportunities surrounding assignments of accounts receivables. Accordingly, this chapter examines and compares the law and practice of account receivables in China, the United States of America, and the United Kingdom. The analysis is based on the assignment of account receivables ranging from traditional factoring, forfeiting, to modern cross-border securitization transactions. Through comparison, this chapter concludes by identifying the various legal issues about Chinese law and proposing corresponding solutions.

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<sup>1</sup> Associate Professor of Law, Fudan University School of Law, Shanghai, PRC. E-mail: lygao@fudan.edu.cn.

## 1. Introduction

### *1.1. Evolution of assignment of contractual rights*

Contracts are regarded as private law between the business parties to the transaction because they are based on the agreement of the contracting parties. A contract gives rise to obligations which are enforced or recognized by law. The stability of this “private law” is important because both parties need to perform their obligations according to the contract. If the contract terms or the parties to the contract could be freely changed, the parties as well as any third party creditors may not be able to predict what their rights and obligations would be. Contract law thus provides such a protection by recognizing duly formed contracts and imposing liabilities on the party who fails to perform their contractual obligations.

However, with economic development, contract law has recognized that the business needs of both parties may change, along with the circumstances under which the parties made the contract. In such cases, adherence to the original contract terms may hinder the business transactions. While stability of the contract is still important, flexibility has thus become more and more significant, especially to meet the needs for globalization, in the context of which the business parties come from different countries and it is more likely that their business needs may change over time.

Generally, a contract only binds its two parties. However, after the contract has been made, one of the parties may want to liquidate immediately its future rights under the contract, or find some third party willing to perform its future duties under the contract. To accomplish these ends, contract law has developed the devices of assignment of contractual rights and delegation of contractual duties. This chapter focuses on the assignment of contractual rights, under which the benefits of a contract will be transferred to a third party.<sup>2</sup> More precisely, an assignment of contractual right is a voluntary manifestation of intention by the holder of an existing right to make an immediate transfer of that right to another person.<sup>3</sup> The assignment

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<sup>2</sup> G.H. Treitel, *The Law of Contract* 590 (Sweet & Maxwell 1995).

<sup>3</sup> Brian Blum, *Contracts* 673 (Aspen Law & Business 1998).

of contractual rights is an ideal illustration of the process, and the importance, of maintaining flexibility in contracting.

### *1.2. Account receivables as contractual rights*

One of the most significant uses of assignments in modern law occurs in the context of commercial financing. Where a business sells goods to a purchaser, more often than not the sale is on credit, which means that the purchaser promises to pay the price plus interest at some time in the future. This promise may be converted into money by the seller through assigning of the right to payment to a commercial lender, such as a bank or other financing institution. This is known as accounts receivable financing.<sup>4</sup> The transfer (assignment) of accounts is a mainstay of commercial financing.

The assignment of accounts happens not only within a country, but also worldwide. With the development of the global economy, competition in international trade has become more and more intense. The international market has gradually become purchaser-oriented, and the competition of various industries is fierce. As in domestic businesses, the enterprises of various countries have adopted credit sales in order to expand their participation in the international market. As a result, the sales volume of international trade has been enlarged and the scale of businesses has been expanded. Meanwhile, many enterprises have accumulated more and more account receivables with different due periods, occupying much of the enterprises' capital. On the one hand, the enterprises are facing huge pressure of financing and the risks that large amount of account receivables may not be successfully collected; on the other hand, competition requires that the enterprises continue to offer credit sales, so that new account receivables are accrued continuously. In order to resolve the problem, businesses liquidate their account receivables by assigning them to financial intermediaries.

The assignment of account receivables as an important way of financing has developed quickly in recent years, challenging the laws in different countries. Although account

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<sup>4</sup> John Edward Murray, Jr., *Contracts: Cases and Materials* (5<sup>th</sup> Ed.) 932-33 (Lexis Publishing 2000).

receivables are assigned in both international and domestic contexts, often domestic laws determine whether and to what extent the contractual rights can be freely assigned.

## 2. Assignment of account receivables

### 2.1. Definition

The Uniform Commercial Code of the United States defines “account” as:

a right to payment of a monetary obligation, whether or not earned by performance, (i) for property that has been or is to be sold, leased, licensed, assigned, or otherwise disposed of; (ii) for services rendered or to be rendered; (iii) for a policy of insurance issued or to be issued; (iv) for a secondary obligation incurred or to be incurred; (v) for energy provided or to be provided; (vi) for the use or hire of a vessel under a charter or other contract; (vii) arising out of the use of a credit or charge card or information contained on or for use with the card; or (viii) as winnings in a lottery or other game of chance operated or sponsored by a State, governmental unit of a State, or person licensed or authorized to operate the game by a State or governmental unit of a State.

The term does not include

(i) rights to payment evidenced by chattel paper or an instrument; (ii) commercial tort claims; (iii) deposit accounts; or (iv) rights to payment for money or funds advanced or sold, other than rights arising out of the use of a credit or charge card or information contained on or for use with the card.<sup>5</sup>

Chinese law defines “account receivables” as the rights to payment that the obligee has against the obligor arising out of providing certain goods, services, or facilities, including the

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<sup>5</sup> UCC § 9-102(2).



rights to present and future monetary payment and the proceeds thereof, but excluding the right to payment arising out of negotiable instruments or other securities.<sup>6</sup>

In December 2001, the United Nations issued the Convention on the Assignment of Receivables in the International Trade, in which “assignment” is defined as “the transfer by agreement from one person (“assignor”) to another person (“assignee”) of all or part of or an undivided interest in the assignor’s contractual right to payment of a monetary sum (“receivable”) from a third person (“the debtor”).<sup>7</sup>

The various definitions reflect the different focus of each legal document, but it is generally agreed that account receivables are the right to payment of a monetary obligation. As discussed above, one important purpose of assignment of account receivables is to obtain financing since account receivables are creditors’ rights with significant economic value. In practice, account receivables may be transferred directly or be used as collateral. This chapter focuses on the direct transfer.

## *2.2. General forms of assignment of account receivables*

There are various ways to get financing based on account receivables. The most popular ways include factoring, forfaiting, and securitization of the receivables.

### *2.2.1. Factoring*

“Factoring” is a contract, pursuant to which a supplier may or will assign account receivables to a third party (known as a “factor”) for ledgering receivables, collecting proceeds and protecting against bad debts. Factoring is a full financial package that combines services of credit protection, account receivables’ bookkeeping, and collection of proceeds. Under a factoring contract, the factor agrees to purchase the seller’s account receivables, normally without recourse, and assumes responsibility for the debtor’s financial inability to pay. If the

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<sup>6</sup> Measures on Registration of Pledged Account Receivables, art. 4 (issued by People’s Bank of China in 2007).

<sup>7</sup> See article 2(a) of the Convention.

debtor goes bankrupt or is unable to pay its debts for credit reasons, the factor will pay the seller.<sup>8</sup> People use factoring mainly for consistent cash flow, lower administration costs, reduced credit risks, and more time to concentrate on their core business activity.

Factoring may be traced back to the period of industrial revolution. In order to export its goods, the textile mills in the northern part of England appointed agencies in North America to sell their products and then remit the proceeds back to England. Those agencies were the embryos of factors today.<sup>9</sup>

When the seller and buyer of the account receivables are in different countries, the service is called international factoring. International factoring has developed since the 1960s. The Convention on International Factoring was passed by the International Institute for the Unification of Private Law in May 1988.

International factoring may increase sales in foreign markets by offering competitive terms of sale, protecting against export credit losses, accelerating cash flow through faster collections, lowering costs involved with letter of credit, increasing liquidity to finance working capital, and enhancing borrowing potential. Normally, the supplier (exporter) signs a factoring contract with an export factor in its own country, under which the supplier assigns all export receivables to the export factor and the export factor is responsible for all aspects of the factoring service. The export factor then selects a correspondent to act as import factor in the country to which the exports are being sent. The receivables are reassigned by the export factor to the import factor. Then the import factor will establish credit lines for each of the debtors (importers). The credit lines will be for a specific amount and terms of sales. The export factor confirms the details of the credit lines to the supplier. After the supplier ships the goods and sends an invoice to the importer, the import factor handles the collection of the receivable and promptly remits the payment of the proceeds to the supplier's account with the export factor. If the buyer goes bankrupt when the invoice matures, the factor will assume the credit risk. This is the most advantageous benefit of factoring to the exporter.

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<sup>8</sup> See The Convention on International Factoring (issued by the International Institute for the Unification of Private Law in May 1988).

<sup>9</sup> Peng Lv, *The Origin of International Factoring and its Development Domestically and Internationally*, 24 MODERN BUSINESS (2011).

Factoring started in China from 1980s. In October 1987, Bank of China signed a general factoring agreement with a German loan company, symbolizing the official start of the factoring business in China. In 1992, Bank of China joined the Factors Chain International (FCI), thus becoming the first financial institution engaged in the factoring business in China. The FCI was established in the Netherlands in 1968, with its headquarters in Amsterdam, having more than 100 members. The purpose of the FCI is to provide its members with standard criteria, procedures, law, and technological consulting relating to international factoring. The FCI Code of International Factoring Customs, developed by the FCI Legal Committee, became the world's most widely recognized legal framework for international factoring and served as the prime example for the final text of the Unidroit Convention of International Factoring.<sup>10</sup> In July 2002, the FCI Code was replaced by a newly drafted document, the General Rules for International Factoring (GRIF). The GRIF has provide a new standard for correspondent factoring relationships and probably more than 80% of the world cross-border factoring volume are governed by those rules.

The factoring business in China has thus developed greatly over the past twenty years. However, the laws governing factoring have not been unified but only scattered in the Civil Law, Contract Law, and Property Law. In April 2014, China Banking Regulatory Commission issued Provisional Measures on Administration of Factoring Business Conducted by Commercial Banks. In addition, Ministry of Commerce of China has also approved factoring by non-bank institutions in a couple areas, including Pudong New Area of Shanghai City, allowing business entities to be established within these areas specifically engaging in factoring business. It can be predicted that in the near future, Chinese legislature may consider promulgating a nation-wide law to specify the legal issues in factoring transactions.

### *2.2.2. Forfaiting*

“Forfaiting” is a form of debt discounting for exporters in which a forfaiter accepts at a discount and without recourse promissory notes, bills of exchange, or letters of credit received from a foreign buyer by an exporter. Maturities are normally from one to three

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<sup>10</sup> Stilwell Tu, *International Factoring*, electronically published at <http://www.66law.cn> (2006).

years.<sup>11</sup> The exporter receives payment without risk, at the cost of the discount. Forfaiting is a payment technique an exporter can use to promote sales on a deferred payment basis. By purchasing the credit instruments, the forfaiter deducts interest at an agreed discount rate for the full credit period covered by the notes. In the case of a draft, the debt instrument is drawn by the exporter, accepted by the importer, and will bear an unconditional guarantee. The letter of guarantee will normally be opened by the importer's bank. In exchange for a payment, the forfaiter obtains the right of claiming the debt from the importer, and the forfaiter either holds the drafts or notes until maturity or sells them to another investor on a non-recourse basis.

Forfaiting in its modern form was developed by west European exporters and their banks to finance equipment sales to eastern Europe in the 1950s and 1960s, and has been used in developing markets since the mid-1970s. At that time, east European countries were eager to obtain western technology, but they had little hard currency. On the one hand, east European importer had no access to longer trade credits, for the trade credits provided to them were usually up to six months, not long enough to finance the imports of capital goods. On the other hand, West German manufacturers of capital goods were anxious to expand their markets to east European countries. Since the deals were profitable, West German manufacturers were willing to wait up to five years for payment against negotiable instruments, which had been guaranteed by a state bank of the relevant east European country. However, the difficulty encountered by the West German manufacturers was that they had no access to sufficient funds to offer such extended credits to their buyers. Under these conditions, banks, as crucial important financial intermediaries, stepped into the gap. Swiss, German, and Italian forfaiters played a key role in the evolution of the forfaiting market. These forfaiters agreed to purchase these trade receivables from West German manufacturers for cash, which in turn allowed the manufacturers to continue to expand trade. According to the then applicable negotiable instrument law in Europe, a holder of commercial papers at maturity had a right of recourse against all previous parties of the paper and ultimately the drawer, in the event of being not paid on the due date. But in order to keep the trade simple, no matter whether they were bills of exchange drawn by the exporter or promissory notes made out by the importer, once the exporter became the bona fide holder of the negotiable

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<sup>11</sup> Liming Xu, *Research on Functions of Forfaiting*, 30 CREDIT REFERENCE 2 (2012).

instruments, the exporter could sell it to a forfaiter at a discount and obtained immediate payment. This sale was without recourse to the exporter, but the security for the forfaiter was the guarantee of the importer's bank.

Among the advantages of forfaiting are that it eliminates political, transfer, and commercial risks; and it protects against risks arising from the fluctuation of exchange rates. In addition, the exporter obtains 100% of finance for the contract value, making its exports more competitive and facilitating its exports to high risk areas. Forfaiting turns credits into cash, thus not tying up the exporter's working capital and bettering the exporter's financial conditions. The documents and procedures are quite simple.

Forfaiting started in China since 1994, but there is no specific law governing forfaiting in China. The relevant rules are also scattered in the Civil Law, Contract Law, and Property Law.

### *2.2.3. Securitization*

Securitization originated in the 1970s firstly from the United States and later developed in many countries including civil law countries. Securitization is one type of structured financing under which the enterprise that needs financing sets aside part of its assets which may bring about stable cash flow in the future; then divide them into smaller units; and finally sell them to the capital market's investors. Most of the time, the assets are financial assets, i.e., account receivables. By doing so, the enterprise that needs financing (sometimes called "initiator") converts the account receivables into cash, diversifying the risks and obtaining financing with lower costs.<sup>12</sup> Through securitization, the enterprise that generates the account receivables is able to sell them directly to investors.

Generally, securitization is designed through establishing a special purpose vehicle (SPV) which may take the form of a trust or a corporation. In order to achieve the goal of "bankruptcy-remoteness," local law may require the transfer of the account receivables to be "true sale" so that the bankruptcy law will not regard the securitized account receivables as

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<sup>12</sup> Steven L. Schwarcz, *Commercial Trusts as Business Organizations: Unraveling the Mystery*, 58 BUS. LAW. 559, 562-63 (2003).

part of a bankruptcy estate. The SPV needs to pay consideration to the initiator for receiving the account receivables. The money paid to the initiator can be raised through loans, or through issuing securities to the capital market.<sup>13</sup>

While securitization has developed furthest in the United States, it has also expanded to many other countries, even including civil law countries such as Japan and Korea. China also allows banks and financial institutions to securitize their account receivables as a way of financing.

Although the aforementioned three ways of assigning account receivables are different, they all involve the laws governing the assignment of contractual rights. Since national laws vary in this regard, the following section tries to compare the different rules.

### *2.3. Comparison*

While economic development pushes each country to encourage business transactions and promote various ways of financing, the law of every country may be different regarding the assignment of account receivables. This section will introduce the laws of a few countries governing the assignment of account receivables, namely, the English common law, US law, and Chinese law. The reason for selecting laws of these three countries is partly because the UK and the US are typical common law countries and China is a civil law country. While the laws on assignment of contractual rights have been quite developed in the UK and the US, Chinese law in this regard is still at its developing stage. The introduction of the relevant laws in these countries has different focus. The introduction to the UK law mainly illustrates the historical development of the law in this area, the introduction to the US law focuses on its current effect, and the introduction to the Chinese law is aimed to identifying the issues.

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<sup>13</sup> See generally, Lingyun Gao, *Trust Law – A Misunderstood System* Ch.8 (4) (Fudan University Press 2010).

### *2.3.1. English common law*

The early common law developed a general rule that an attempted assignment of a contract right was of no legal effect whatever.<sup>14</sup> The common law refused to acknowledge assignments of contractual rights because the contractual rights were regarded as “choses in action,” which means it could only be asserted by bringing an action and not by taking possession of a physical thing. “The early lawyers found it hard to think of a transfer of something intangible like a contractual right.”<sup>15</sup> However, contractual rights were transferrable in equity in England based on commercial convenience.<sup>16</sup> But according to English common law certain contractual rights even now may not be assigned. These include contracts expressed to be not assignable, personal contracts, and mere rights of action.

The first restriction is that if a contract provides that the right arising under it shall not be assigned, a purported assignment of such rights is not only a breach of that contract but is also ineffective, in the sense that it does not give the assignee any rights against the obligor.<sup>17</sup> However, an assignment of the benefit of a contract which is expressed to be not assignable may be binding as a contract between assignor and assignee. Another important restriction is that the benefit of a contract cannot be assigned if it is clear that the obligor is only willing to perform in favor of one particular creditor, and if it would be unjust to force him to perform in favor of another. In other words, the personal nature of the contract prevents assignment.<sup>18</sup>

### *2.3.2. US law*

Laws within the United States favor the free transferability of contractual rights and are inclined to uphold the right of a party to make such a transfer. The general rule is that unless a contract specifically prohibits a party from transferring his rights acquired under it, or the nature of the contract is such that the transfer would impair the other party’s reasonable

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<sup>14</sup> See generally Bailey (1998) *Assignments of Debts in England from the Twelfth to the Twentieth Century*, in Blum, Brian (1998) *Contracts*. Aspen Law & Business.

<sup>15</sup> Pollock and Maitland, II *History of English Law* 226, cited in G.H. Treitel, *The Law of Contract* 590 (Sweet & Maxwell 1995).

<sup>16</sup> G.H. Treitel, *The Law of Contract* 591 (Sweet & Maxwell 1995).

<sup>17</sup> *Helstan Securities Ltd. V. Hertfordshire C.C.* [1978] 3 ALL E.R. 262, cited in G.H. Treitel, *THE LAW OF CONTRACT* 610 (Sweet & Maxwell 1995).

<sup>18</sup> G.H. Treitel, *The Law of Contract* 610 (Sweet & Maxwell 1995).

expectations or would offend public policy, a party has the power to transfer contractual rights and obligations.<sup>19</sup> This principle is well established by US law. The underlying rationale is that an obligee's right to performance under the contract is one of his assets – an item of property with some value. Although it is intangible, it is his property all the same, and he should be able to dispose of it if he so desires.

As with English law, US law has also imposed restrictions on the right to assign contractual rights. The first restriction is that an assignment cannot be validly made if the contract prohibits it. However, US law requires that such a prohibition must be clearly expressed in the contract, since the law generally favors assignment. Actually, the Restatement of Contract (2<sup>nd</sup>) and the Uniform Commercial Code (UCC) restrictively interpret contract provisions that preclude assignment of contractual rights.<sup>20</sup> Any doubt or ambiguity should be resolved in favor of transferability, and most of the time, a provision that prohibits “assignment of the contract” should be taken to forbid only the delegation of duties. Even if a provision of the contract definitely does prohibit assignment, unless the contrary intent is clear a US court would assume that the assignment of contractual rights is itself effective. At the same time, however, there is a breach so that the obligor could seek a remedy.

Other restrictions may include that an assignment would not be effective if the nature of the contract prevents the assignment; or if the assignment would materially change the obligor's duty, increase the burden or risk imposed by the contract, impair the other party's prospects of getting return performance, or otherwise substantially reduce its value to the other party. Every assignment is likely to have some effect on the obligor's duty, even if nothing more than having to make a payment to someone other than the person with whom the party contracted. There must be a balance between stability and flexibility. Therefore, the requirement of material impact prevents the obligor from resisting an assignment on the basis of some trivial change in his performance obligation.

After a valid assignment is made, the assignee substitutes for the assignor as the person to whom performance must be rendered. It therefore follows that although the obligor need not be a party to or assent to the assignment to make it effective, he must be notified of it so that

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<sup>19</sup> Brian Blum, *Contracts* 673 (Aspen Law & Business 1998).

<sup>20</sup> Restatement of Contract (2<sup>nd</sup>) § 322; UCC § 2.210(3).



he knows the person to whom performance is now due. There is no particular formality required for the notice, provided that it coherently indicates what right has been assigned, and to whom. The notice must be received by the obligor – that is, it must either come to his attention, or be delivered so that he reasonably should be aware of it. Either the assignor or the assignee may give this notice, but if it comes from the assignee the obligor is entitled to adequate proof of the assignment.

When rights are assigned, the general rule is that the assignee can get no greater right against the obligor than the assignor had. This means that the assignee takes the rights subject to any conditions and defenses that the obligor may have against the assignor arising out of the contract. The obligor may only use the assignor's breach defensively against the assignee. That is, the assignor's breach operates as a defense to the assignee's claim, and damages due to the obligor by the assignor may be offset against the assignee's claim. However, the assignee has no liability for the obligor's damages to the extent that they exceed the amount of the offset.

The obligor's right to assert defenses arising out of the contract is not cut off by the notice of assignment, so the defense is available against the assignee whether the basis for it arose before or after the obligor received notice. However, the notice does affect any claim of set-off that the obligor may have against the assignor, arising out of a different transaction. The rule is that the assignee's rights are subject to any such right of set-off that arose before a notice of assignment, but cannot be defeated by one that arose afterwards.

Unless the assignment indicates an intent to the contrary, the assignor impliedly warrants to the assignee that the rights assigned are valid and not subject to any defenses. Therefore, if the obligor successfully raises a defense against the assignee, the assignee usually has a cause of action against the assignor for breach of this warranty.<sup>21</sup>

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<sup>21</sup> See generally, Brian Blum, CONTRACTS 676-79 (Aspen Law & Business 1998).

### 2.3.3. Chinese law

The Chinese law also recognizes the assignment of contractual rights and regards it as a change of parties to the contract. In essence, under Chinese law, assignment of contractual rights means that the parties to a duly formed contract may assign their contractual rights to a third person without changing the terms of the contract.<sup>22</sup> Article 79 of the Chinese Contract Law provides that the obligee may assign all or part of its contractual rights to a third party. Chinese law allows the obligee to assign its contractual rights to a third party as long as the assignment does not violate law or social ethics. The underlying rationale is that the assignment of contracts may encourage transactions and promote development of the market economy. However, in order to protect the public interest and maintain an orderly marketplace, as well as to balance the rights and interests of both parties, Chinese law also limits the scope of the assignment of contractual rights.<sup>23</sup>

According to Chinese law, there are three situations in which the contractual rights are not assignable: First, if the nature of the contractual rights makes them un-assignable, then the contractual rights may not be assigned to a third party. Similarly to the restrictions imposed by the English law and US law, this is the case mainly for contracts that are personal, or that are secondary to a primary contract. Second, if on concluding the contract the parties agree that the obligee must not assign its contractual rights to a third party, then the contractual rights are not assignable as long as such an agreement does not in itself violate the law. This resembles English law. However, such an anti-assignment agreement is not effective against a bona fide third party. Third, if the law prohibits a transfer of contractual rights, then they cannot be transferred.<sup>24</sup> If the law imposes any special requirements on the assignment of contractual rights, those requirements must be complied with.<sup>25</sup>

When assigning contractual rights, the assignor and assignee must agree on the assignment and cannot change the terms of the original contract. The assignor must be the obligee, with

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<sup>22</sup> Lingyun Gao, et al, II SERIES ON CONTEMPORARY CHINESE LAW: CHINESE BUSINESS LAW 151 (Thomson West 2008).

<sup>23</sup> *Contract Law of the People's Republic of China* (hereinafter, "Chinese Contract Law") art. 79 (1999).

<sup>24</sup> *Chinese Contract Law* art.79 (1999).

<sup>25</sup> *Chinese Contract Law* art. 87 (1999).

full legal capacity to dispose of its rights. The assignment by an obligee with only limited legal capacity will not be completed unless made by its legal representative or duly authorized agent. Article 91 of the General Provisions of Chinese Civil Law (hereinafter, “Chinese Civil Law”) requires an assignor of contractual rights to obtain prior consent from the other party before the assignment. The Chinese Civil Law also prohibits the assignor from making profits from the assignment or delegation.<sup>26</sup> However, article 80 of the Chinese Contract Law does not require an assignor to obtain prior consent from the other party, but only requires that the assignor notify the other party about the assignment. The law does not mention the profit-making prohibition, either.<sup>27</sup> The discrepancy between the two laws on this point is quite obvious. However, if the assignment of contractual rights will not infringe the other party’s lawful interests or increase the other party’s burden, the law does not need to intervene as long as the assignment is free from fraud, duress, undue influence, significant misunderstanding, or unconscionability.

After assignment has been completed, it becomes effective both between the assignor and the assignee, and among the assignor (obligee), assignee, and the obligor of the original contract. As between the assignor and the assignee, the contractual rights have been assigned by the assignor to the assignee. The assignment will be effective after the obligor has received the notice according to Article 80 of the Chinese Contract Law. If the assignor assigns all of its contractual rights to the assignee, then the assignee will become a new obligee having the same rights as the original obligee, and may request the obligor to perform the contract to the new obligee. If the assignor assigns only part of its contractual rights to the assignee, then the assignee will join the contractual relationship to be a co-obligee. The assignment contract may clarify whether the assignor and the assignee will enjoy their contractual rights in shares or jointly. If the contract is silent on the point, then the law will presume that they will jointly exercise their contractual rights. Upon assignment, any secondary rights affiliated with the primary rights also are assigned to the assignee, except for those that are personal.<sup>28</sup> In addition, upon assignment, the assignor warrants that the assigned rights are free from defects and that the assignor will be liable for any damage caused by defects.

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<sup>26</sup> *Chinese Civil Law* art. 91 (1986).

<sup>27</sup> *Chinese Contract Law* art. 80 (1999).

<sup>28</sup> *Chinese Contract Law* art. 81 (1999).

Concerning the assignor (obligee), assignee, and the obligor, if the contractual rights have been completely assigned to an assignee, then the original obligee is out of the original contractual relationship and can no longer ask the obligor to perform the contract. If only part of the contractual rights have been assigned, and the assignor and assignee have their interests in shares, then the obligor must satisfy contractual obligations to both of them, provided that any increased cost of performance is borne by the original obligee based on the principle of honesty and good faith. After receiving the notice of assignment, the obligor must perform its contractual obligations to the new obligee to the extent that the contractual rights are assigned. However, the obligor may have a claim against the assignee on the ground of defenses he has against the original obligee, including the concurrent-performance defense, later-performance defense, and defense of insecurity. Furthermore, if the obligor has a creditor's right against the assignor, the obligor may claim a set-off against the assignee when it is due. In addition, if the assignee sues the obligor to resolve disputes arising from performance of the contract, and if the obligor raises a defense against the obligee's rights, the court may ask the obligee to be a third party to the litigation.<sup>29</sup>

#### 2.3.4. Summary

The above introduction illustrates the development of the laws governing assignment of account receivables in a few different countries and demonstrates that both the civil law and the common law allow assignment of contractual rights, but subject to certain restrictions. While the nature of the contract and a prohibitive article of any law may prevent an assignment, the parties may also agree in the contract that the contractual rights are not assignable. Most of the countries would give effect to such an anti-assignment clause, but each country may adopt a different view. For example, the United States would assume transferability is the general rule, and an anti-assignment clause must be clearly stated in the contract and not violate other laws. Also, even if such a clause will be given effect, the Chinese law, for example, would only regard such a prohibitive clause as effective between the parties, but not against bona fide third party.

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<sup>29</sup> Interpretation of the Supreme People's Court of the People's Republic of China on the Application of the Contract Law (hereinafter, "SPC's Interpretation on Contract Law) art. 7 (1999).

#### *2.4. Main issues and solutions*

Various problems arise from assignment of contractual rights, and account receivables in particular. These include the legal prohibition of transfer of contractual rights, the effect of the anti-assignment clause in the contract, the effect of the transfer of future account receivables, and the form of assignment. Below are some refinements of these problems, and some suggested solutions, based mainly on Chinese law.

The first issue is quite fundamental. Although Chinese law generally allows assignment of contractual rights, the definition of contract for sale as defined in the Chinese Civil Law and Contract Law is too narrow and has not considered the transfer of contractual rights. Unlike the German Civil Code which provides that a contract for sale is not only for goods, but also for rights (including the sale of creditor's rights, i.e., contractual rights<sup>30</sup>), the Chinese Contract Law only recognizes the sale of goods, not the sale of rights, as a sales contract.<sup>31</sup> Therefore, the assignment of contractual rights may need to be protected and regulated by the laws other than the Contract Law in China. Actually, Chinese Property Law has recognized the account receivables as a right which may be pledged in order to facilitate the assignment of the account receivables. However, there are two conditions: first, there must be a certificate of rights or registration system; second, there must be possession of the certificate of rights or through registration. Currently there is no certificate of rights that can be issued to account receivable holders, and neither is there a registration system.

The second issue is that article 91 of the Chinese Civil Law of 1986 allows the assignment of contractual rights but prohibits the assignor from making profits out of the assignment. It also requires that the assignor must obtain the obligor's consent regarding the assignment. This provision has actually prevented the development of the assignment of account receivables in China. The Chinese Contract Law of 1999 has removed the "consent" requirement and only required the assignor to notify the obligor. It has also eliminated the non-profit prohibition. Although the Contract Law has made significant improvement in this regard, it does not resolve all the issues. For instance, articles 79-83 and 87 have only considered general

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<sup>30</sup> Liming Wang, *A Comparison of Sales Contract between China and Germany*, 1 RESEARCH ON COMPARITIVE LAW (2001).

<sup>31</sup> *Chinese Contract Law* art.174 (1999).

situations such as the situations where contractual rights are non-assignable, the notification requirement, the defenses and right to set-off that the obligor may have, etc. It does not make further detailed regulations on the important issues regarding whether future account receivables are assignable, the forms of assignment of account receivables, the effect of an anti-assignment clause, or the resolution of priority issues.

The third issue regards the effect of the anti-assignment clause in the contract. As introduced above, both UK law and US law allow the assignment of account receivables, with US courts adopting a more liberal attitude toward assignability. The UK law recognizes the effect of the anti-assignment clause as against third parties, but under US law, even if the parties clearly stipulate in the contract that the contractual rights cannot be assigned, such an anti-assignment clause is not effective against bona fide third party. Section 210 (2) of the UCC provides the general rule that all contractual rights are assignable, except if the assignment will materially change the other party's obligation, or materially increase the other party's burden or risk. The anti-assignment clause is narrowly interpreted as a prohibition of transfer of the contractual duties only. The civil law attitude toward the anti-assignment clause is also different. The German Civil Code gives full effect to the anti-assignment clause like UK law, while the French Civil Code does not give any effect to the clause. Chinese law basically recognizes the effect of such anti-assignment clause according to article 79 of the Contract Law, but it does not specify various situations.

Based on the above analysis, solutions are proposed that the Chinese law should make changes.

First, its Contract Law should clearly allow the assignment of contractual rights so that contract flexibility in business transactions is to be enhanced. To this end, the Contract Law should clearly cover the sale of rights, especially after the Property Law which was promulgated later than the Contract Law already recognized the sale of rights. It should also clearly recognize the effect of assignment of future receivables considering the Chinese government is promoting asset securitization in the recent years. Actually, the UN Convention on the Assignment of Receivables in International Trade ("Convention on

Assignment of Receivables”) has explicitly recognized that future receivables are assignable.<sup>32</sup>

Secondly, in order to facilitate the assignment of contractual rights, Chinese law should stick to the mere notification requirement and not require the assignor to obtain consent from the obligor upon assignment of the contractual rights. By doing so, the Chinese practice will be in line with the other countries’ practice as well as the UN Convention on the Assignment of Receivables. The Convention adopts the “notification” approach to invalidate the assignment of contractual rights.<sup>33</sup>

Thirdly, the effect of anti-assignment clause should be given deference, but subject to certain restrictions. The law should be changed to at least recognize that the anti-assignment clause should not be effective against a bona fide third party. The UN Convention on Assignment of Account Receivables adopts an attitude in disfavor of the anti-assignment clause which is also in line with some countries’ practice, and it provides that: “[a]n assignment of a receivable is effective notwithstanding any agreement between the initial or any subsequent assignor and the debtor or any subsequent assignee limiting in any way the assignor’s right to assign its receivables.”<sup>34</sup>

In addition, China needs to consider joining the United Nations Convention on the Assignment of Receivables in International Trade of 2001, or at least participate in discussions and cooperations with the other countries with regard to the assignment of account receivables, and revise its laws accordingly.

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<sup>32</sup> See article 8.1 of the Convention, which provides: “[a]n assignment is not ineffective as between the assignor and the assignee or as against the debtor or as against a competing claimant, and the right of an assignee may not be denied priority, on the ground that it is an assignment of ... future receivables...”

<sup>33</sup> See article 13.1 of the UN Convention on Assignment of Account Receivables, which provides: “[u]nless otherwise agreed between the assignor and the assignee, the assignor or the assignee or both may send the debtor notification of the assignment...”

<sup>34</sup> See article 9.1 of the UN Convention on Assignment of Account Receivables.

### 3. Conclusive remarks

The title of this chapter covers a wide range, but owing to various limitations, this chapter mainly focuses on issues regarding assignment of contractual rights. Flexibility in contracting may have various layers of meaning, but the assignment of contractual rights is vital to the commercial well-being of many businesses. If the laws of different countries could be reconciled regarding such an assignment, business transactions will be further promoted and facilitated.

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# Promoting Contract Flexibility through Trademarks: “Branded” Intellectual Property Licensing Practices

NARI LEE,<sup>1</sup> THOMAS D. BARTON<sup>2</sup>

Contract inflexibility seems to stem from two motivations: the urge to *control the future*, and a quest to *improve economic efficiency*. In thinking about whether and how contract inflexibility might be reduced, those human motivations must be taken into account. Reforms aimed at greater flexibility might better fit modern economic, organizational, and technological conditions, but if the underlying human motivations that produce inflexibility are ignored, then the reforms are likely to be ineffective<sup>3</sup> or even counterproductive.<sup>4</sup>

This paper reflects on both the “future control” and “efficiency-seeking” impulses toward inflexibility, asking whether modern trends are changing the underlying assumptions of those impulses. Then, it examines a novel and still-evolving approach to intellectual property licensing—“branded licensing”—that has potentially broad application in transcending these motivations toward inflexibility. The branded licensing approach may achieve greater flexibility without compromising stability, the need for which prompts the urge to control the future. Branded licensing offers this greater flexibility without significantly increasing transaction costs, which prompts the concern about efficiency. “Branding” may thus represent a new structure for contracting that will be attractive psychologically, as well as legally and economically. Although as yet visible only in Intellectual Property licensing—examples of which are presented below—the branding concept could be developed in other contracting contexts.

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<sup>1</sup> Professor of Intellectual Property Law, Dep’t of Accounting and Commercial Law, HANKEN School of Economics, Helsinki, Finland.

<sup>2</sup> Louis and Hermione Brown Professor of Law, California Western School of Law, San Diego, California, USA.

<sup>3</sup> Dauer Edward A., *The Role of Culture in Legal Risk Management*, 49 SCANDINAVIAN STUDIES IN LAW 93 (2006).

<sup>4</sup> Moore Sally Falk, *LAW AS PROCESS: AN ANTHROPOLOGICAL APPROACH* 58-65 (1983).

## 1. Why Are Contracts Traditionally So Inflexible?

### 1.1. *Controlling the Future Through Legal Imperatives*

At least in part, people demand inflexibility in contracts because they want to control the future. This impulse may sound obsessive, but it is actually sensible. A perceived need for “future control” is best understood if we imagine a world without legally enforceable contracts. Exchange would proceed only where the performances of both parties are immediate—a synchronous transaction as in retail sales or bartering—or where one party is trusted to delay performance to some future moment. Absent that trust or some other non-contractual leverage like taking property as security against performance, the exchange will be too risky to undertake. Further, the greater the turbulence of background market or personal considerations, the harder it is to trust the other person. The greater the fluctuation of environmental conditions, in other words, the higher the risk of trusting that future performances will actually be made. A stable future reduces risk, heightens trust, and enables more transactions. If the *reality* of the future cannot be fully predicted or controlled, then creating a future *artificially* through contracts will supply that needed stability.

Legally enforceable promises—i.e., contracts—are thus a breakthrough in the history of human exchange. Even without preexisting trust between the parties, contracts can provide the stability on which putting one’s trust in another person’s future performance becomes a tolerable risk. Therefore the performances of the contracting parties need not occur simultaneously. By bringing the power of the state to bear on future performances, *regardless of then-prevailing economic or personal conditions*, contracts permit the reciprocal duties of an exchange to be reliably performed even though *asynchronous*. The de-coupling in time of the performances dramatically increases the potential for parties to find mutually beneficial exchanges. It stabilizes transactions over time by smoothing out the effects of market fluctuations, permits risks to be more readily calculated, and enables stronger planning and confidence in resource allocation. Controlling the future through the law thus facilitates interpersonal trust, and the feasibility of contracts. It is natural, therefore, that the “future-control” impulse is so strongly felt among the commercial community. The trouble lies when that impulse turns into instinctive contractual inflexibility.

Safeguarding the reliability of this invention for asynchronous exchange—“contracts”—no doubt explains why early contract law was so restrictive in releasing parties from their obligations, even where background conditions had become highly impracticable or unprofitable. To gain the benefits of the contract device seemed to require that people be clear in what they demanded of their counterparts’ future performances; it also seemed to require that contract law be forceful in enforcing the parties’ original intentions. That is indeed how contract law classically evolved: excuses from performing as specified were only sparingly allowed, and contract language interpretation instinctively circled back to the parties’ intentions.

“Flexibility” is not valued in such a conceptualization. Flexibility seems inconsistent, at least on the surface, with capturing the efficiencies that flow from ensuring future performances—from “controlling the future.” If a contract could reliably specify what *shall* be, then what really *is* when the time for performance arrives is irrelevant. Contracts are designed to define *legally* what future conditions shall obtain, and the parties should behave accordingly. “Flexibility” may seem to undermine that valuable legal suspension from reality.

Modernly, however, the rate of change in markets, organizations, and technology may be accelerating so dramatically that “freezing” the future through classical contracting may introduce new risks. Where an environment changes constantly, both buyers and sellers may begin to perceive flexibility as offering stronger opportunities and perceive commitments as threatening stronger risks. One of us has likened this to bridge building in an earthquake-prone region. One possible way to overcome the risk of an unpredictably shifting environment is to engineer massive inflexible strength into the bridge—often at significant cost. *Or* one can design a bridge that is *itself* flexible, one that will move with earth tremors so that the bridge never loses structural integrity. So also with contracting: in some environments (which may be quickly proliferating), designing contracts and contract processes to be flexible rather than inflexible may actually *reduce* risks and increase opportunities. Stability may be achieved, in other words, through inflexibility *or* through thoughtful flexibility. Indeed, stability is sometimes *better* achieved through flexible structures and good communications rather than through inflexible demands with expensive and often bruising enforcement methods.

## 1.2. *Efficiency Through Standardization*

The second reason why people may demand inflexibility in their contracts is to better enable the standardization of those contracts. Standardization promotes efficiency by reducing the time spent on contract drafting. People may want to mass-produce a contract that is optimally drafted for the most commonly prevailing conditions. This mentality demands contract inflexibility in the form of a standardized agreement that is offered on a take-it-or-leave-it basis, a “contract of adhesion.” Deviating from a standardized agreement raises a specter of substantially higher transaction costs, and greater liability risks from relatively inexperienced or unapproved language being inserted into a tried-and-true document.

This inflexibility is more often visible in consumer transactions in which little or no bargaining is possible, except perhaps on price or length of warranty. A typical consumer contract in electronic and mobile commerce is represented by what is often called “Click-through” contracts or licenses.<sup>5</sup> “Click-through” arrangements for electronic transactions differ little in this regard from the insertion of printed warranty terms in the packaging of tangible items. Certainly time and lawyer fees are saved by producing and using standardized contracts. Inflexibility, again, seems at first blush to be efficient.

Using standardized contracts either in consumer transactions or in business to business contexts assumes, however, a hierarchy between the parties. The creator of the contract seems to impose its terms on the receiver of the contract, empowered over the other and able to harness that power to press the contract terms onto the subordinated party. The source of the dominant power could be economic—a stronger market position—or it could be more “structural,” reflecting dramatic disparities in sophistication and capability to draft and understand contractual language. Regardless of its source, the ability to impose a standardized (usually unread) contract onto another party suggests strongly that one party will “win” and the other “lose” in the transaction.

In wielding potential legal tools like “unconscionability” or “undue influence” that might allow escape from such contracts, courts tend to be cautious. Courts are mindful of the

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<sup>5</sup> See generally Kim Nancy S., *WRAP CONTRACTS: FOUNDATIONS AND RAMIFICATIONS* (NEW YORK: OXFORD UNIVERSITY PRESS 2013)

business realities that seem to underlie the use of standardized contracts.<sup>6</sup> If the only choices that appear available are: (1) to uphold standardized contracts even though they seem to make a mockery of traditional contract assumptions about bargained-for exchange; or (2) to impose a standard in which the parties come to a real “meeting of the minds,” courts typically permit the use of standardized contracts because requiring true consent to the terms by both parties would seemingly paralyze modern commerce. This issue is of vital concern not only to modern commerce, but also to the perception and reality of meaningful participation in that exchange. Thankfully, as we develop below, the choices for the law may not be completely binary between one-sided standardized contracts, versus unrealistic and hugely expensive personalized negotiation.

Emerging alternatives--what we here call “branded” contracts or licensing--are potentially more than just compromises or trade-offs between efficiency and justice. We argue that branded contracting may introduce a way to make contracting *both* more efficient and more equitable, despite some shortcomings. Just as people should not necessarily equate “inflexibility” with “stability,” so also people should not necessarily equate “inflexibility” with “efficiency.” We can imagine instances in which greater stability is achieved through flexibility, and we can also imagine instances of greater efficiency and equity being achieved through flexibility.

Hierarchy and power-imposition are the problem-solving tools of an era that is being replaced by a more level and participatory world.<sup>7</sup> As these cultural trends proceed, we may speculate that consumers will eventually rebel against the dis-empowering dictates of standardized contracts. They may demand legislation that will regulate various transactions to mandate more balanced relationships between vendor and buyer/licensee. Such regulatory solutions, however, are quite likely to *add* to inflexibility, although they may achieve stronger distributional fairness. More imaginative private or private/public partnership possibilities such as branded licensing could conceivably achieve stronger fairness, *even while increasing the flexibility in contracting that better serves modern businesses and organizations*. The next section introduces both the idea, and the cultural underpinnings, of this branded approach.

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<sup>6</sup> *ProCD, Inc. v. Zeidenberg*, 86 F.3d 1447 (7th Cir. 1996).

<sup>7</sup> Friedman Thomas L., *THE WORLD EARTH IS FLAT: A BRIEF HISTORY OF THE TWENTY-FIRST CENTURY* (2005).

## 2. Intellectual Property and Contracts: Parallels

### 2.1. *Background: The Culture of Collaboration versus Culture of Permission*

As Intellectual Property law has evolved alongside information technology, ideas about the preconditions for creativity and innovation seem to diverge in contradictory directions: toward a culture of “collaboration,” or a culture of “permission.” “Collaboration” emphasizes free exchange and open communication under a foundational metaphor of the “commons” in which an entire community shares access to a resource. Individual members of the community are free to take from the commons, and are encouraged to contribute to its well-being and growth: no one “owns” the commons in the sense of being able to exclude or control access. Collaborationist culture emphasizes organic growth through the gathering of diverse ideas and resources, like Wikipedia.

“Permission,” by contrast, emphasizes legal entitlements and control of both property and information under a foundational metaphor of “enclosure.”<sup>8</sup> A Permission culture assumes that innovation depends on incentives for profits that come from the ability to control and sell access to ideas.<sup>9</sup> In this cultural model, any use of an innovation or creative expression would require permission from the right holders. Ideas and creations are protected by legally-enforced property rights. The property title holders may restrict the use of these abstract objects and any users may need to seek permissions from the right holders. Only by assuring entitlement to such payments for permissive use, claim the advocates of Permission culture, will innovators have a proper incentive for investing the time, resources, and mental energy required for creativity.

Both Collaborationist and Permissive cultures are defensible, but each is vulnerable when taken to an extreme. Collaborationist culture is subject to the “tragedy of the commons,”<sup>10</sup> which is a phrase coined by Garret Hardin to describe what is seen as the inevitable depletion of resources, where there is no formal owner of a resource, and hence no mechanism for limiting access to it. If use of a resource is free, then people will withdraw units of the

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<sup>8</sup> Boyle James, *The Second Enclosure Movement and the Construction of the Public Domain*, 66 LAW & CONTEMPORARY PROBLEMS 33 (2003).

<sup>9</sup> Posner Richard A., *THE ECONOMICS OF JUSTICE* 146-168 (1981); *see generally* Landes William M. and Posner Richard A., *THE ECONOMIC STRUCTURE OF INTELLECTUAL PROPERTY LAW* (2003).

<sup>10</sup> Hardin Garret, *The Tragedy of the Commons*, 162 SCIENCE 1243 (1968).

resource while leaving its replenishment to others. Even if we take into consideration that intangible intellectual resources may be non-rivalous, the resources required to *create and innovate* those resources may be rivalous. The tragedy is that unfettered usage in the commons property will lead to no resources being available to anyone: most people will simply take the free resource and not contribute to its sustainability.

On the other hand, a Permission culture is vulnerable to ossification. Where resources—tangible, intellectual, or cultural—are not shared or otherwise distributed, they can never grow.<sup>11</sup> Economic efficiency assumes that resources should flow—by sale or otherwise—to their highest and best use. They should move to those who value the resource most, presumably because the resource is most productive in their hands. Intellectual innovation is similar: unless ideas circulate, they will not thrive or spark the imagination of people who would build on the idea. But Permission culture would theoretically permit property and ideas to be locked up, under-used and hence become both stagnant and inefficient. The exclusive property that a Permission culture presupposes is subject to a tragedy of another kind – the tragedy of the anti-commons, where the pervasive exclusion leads to under-use or non-use of the protected innovation.<sup>12</sup> Avoiding inefficient ossification is what prompts the law historically to adopt policies in favor of free alienability of property and to prohibit the long-term freezing of property. Rules under intellectual property laws that grant statutory licenses or compulsory licenses under certain conditions are also examples where the law aims to prevent lock-up and under use.<sup>13</sup>

Neither Collaboration nor Permission should therefore be embraced without limitation. Society is best served by viewing them *not* as mutually exclusive, binary opposites, but instead as thriving only when used in combination. Innovation and efficiency require a *blend* of Permission and Collaboration, just as social stability is best achieved through a blend of rules and flexibility. What appear to be antagonistic modes of human behavior—Permission

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<sup>11</sup> Hyde Lewis, *Common As Air: Revolution, Art, and Ownership* (2010).

<sup>12</sup> Heller Michael A. & Eisenberg Rebecca S., *Can Patents Deter Innovation? The Anticommons in Biomedical Research* 280 *SCIENCE* 641(1998).

<sup>13</sup> Non-working of a patented invention, for example, in some jurisdictions give rise to compulsory licensing, just as in an anti-competitive or unreasonable refusal to license a patent. Conditions for grants of compulsory licensing, for example, is set internationally in Article 30, of the Agreement on Trade-Related Aspects of Intellectual Property Rights, (TRIPs) Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1C, 1869 U.N.T.S. 299, available at [http://www.wto.org/english/tratop\\_e/trips\\_e/t\\_agm1\\_e.htm](http://www.wto.org/english/tratop_e/trips_e/t_agm1_e.htm) (last visited May 6, 2013).



versus Collaboration--are better viewed as differing but potentially complementary values. The trick is to build structures that will enable complementarity: structures that legitimately bring together the qualities of rules *and* flexibility, Permission *with* Collaboration.

Ironically, building frameworks open to these diverse values may be easier in social relationships than in Intellectual Property. In social settings, we are accustomed to a broad and informal range of flexibility in the interactional rules that characterize families and friendships. Sharing is valued, but so is saying “please” and “thank you.” Intellectual Property, by contrast, is a set of abstract legal constructs that the law seems historically to have tied strongly to Permission culture and its assumptions.

Intellectual Proprietary Rights (“IPR”) are created by the law, but then also become the primary tools by which Permission culture realizes its outlook on the world. IPR takes information that flows through the intellectual commons of “knowledge” and “education” and encloses some forms of that information into property rights. Access to those rights is then controlled through legally-enforced permissions (although the law does sometimes require “sharing” through doctrines like “fair use” and “mandatory licensing”). Collaborationist culture seems to have no equivalent formal or institutional structure. So engrained are we with the idea that resources are protectable only through reducing them to property rights, that it becomes difficult even to imagine how a Collaborationist outlook could be enforced. Can sharing be mandated? Can generosity be legislated? However elusive it may be to build institutional props for Collaboration culture, many creators nonetheless view the legal IPR structure as stifling and failing to achieve the balance between control and sharing that is optimal for either innovation or distributional justice.

Are the critics correct in that assessment? Does the law overly stress Permission at the expense of Collaboration? And if so, how may the law correct it?

Those responding “yes” to the first two questions above may say that by turning to IPR as its primary method for defining the relationship between intellectual creator and user, the law inherently defaults toward Permission. IPR sets up entitlements for exclusion that must be purchased by users. The law could instead have created something like “IAR” (Intellectual Access Rights) that defaulted to entitlements for sharing, requiring those who would seek

exclusive control to have purchased that right from society generally.<sup>14</sup> But the law generally did not do that. It gave the first entitlement to creators rather than users, perhaps because that arrangement fit so easily within pre-existing legal structures, *or perhaps out of the same instincts or impulses that push toward contract inflexibility: concerns to keep control over the future of resources and to protect efficiency.*

For whatever reason, IPR evolved along lines of traditional property rights and now stands alongside traditional contract law and processes in solidarity with assumptions about the value and need for control, predictability, and individualized entitlements. As we discuss below the particulars of how branded licensing may introduce better flexibility and distribution in Intellectual Property, therefore, we may also imagine its potential broader uses in commercial contracting.

## *2.2. Contracts and Licensing as Potential Bridges Between Permission and Collaboration*

Suppose that an inventor wanted to overcome the tendencies of IPR toward Permission culture. Suppose, in other words, that an inventor wanted to set up a durable Collaborative environment regarding his or her invention. That inventor would have to have: (1) *models* for how to share the inventiveness, so as to build a sustainable “commons;” (2) an ability to *scale* that sharing method efficiently throughout the appropriate community; and (3) the methods must be *accessible*, i.e., comprehensible and readily available to both creator and potential new user.

IPR--and, pushing the analogy further, traditional contract law--seem to fail all three elements. First, IPR and contracts offer little vision for sharing--a normative alternative to the neoclassical image of individual wealth-maximizers. Second, both IPR and contracts struggle to find a method of scaling-up, apart from using standardized language in mass contracts. In IPR settings this takes the form of “click-on” or “click-through” computer-based licensing--a method that has proven to be challenging not only in terms of content, but also in perceived legitimacy of process. Finally, because managing the ownership and use of legal rights is

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<sup>14</sup> Calabresi Guido & Melamed A. Douglas, *Property Rules, Liability Rules and Inalienability: One View of the Cathedral*, 85 HARVARD LAW REVIEW 1089 (1972); *see also* Hyde, *supra* note 9, who suggests a concept of “copyduty” rather than “copyright” (at 220, 245-246).

complex (perhaps especially so in Intellectual Property) both contracts and licenses tend to be inaccessible: they are so difficult to read and understand that few people manage to do either. “Branded” IP licensing practices are a reaction to these perceived shortcomings. First, they have arisen largely among communities that favor Collaboration rather than Permission. And second, they provide an alternative to the traditional poor choices between inefficient, individually negotiated agreements and standardized Contracts that remain unread.

Branded licensing practices typically involve the following steps: (1) a community of people is constructed who become associated with the “brand” or trademark; (2) the community drafts and recommends detailed terms and conditions (or a series of alternative terms, depending on the goals and values of the users) for using particular intellectual property; and (3) the community uses a sign or trademark as a shorthand for the developed terms and conditions that stand in the background behind the brand. By using nothing more than an icon, in branded licensing the parties can agree to abide by terms that have been pre-drafted by a community of interest, reflecting the values of that community.

At some future point, a creator and users, or buyers and sellers could conceivably be able to bargain *meaningfully* about which “brand” of license or contract would govern their transaction. The parties would not necessarily know or understand much about the many terms or conditions that may stand in the background of an icon, but they could come to know and trust the values behind different organizations. Here is a homely analogy: when buying eggs, consumers can choose cartons that say “organic,” “hormone free,” or “free range.” Even though the details of the background practices that those words or phrases actually represent are not spelled out on the carton, the buyer trusts that these background practices are ones that the buyer would endorse. So also in contracting: different persons entering an agreement may have strikingly different values or preferences, but each could advance those preferences by choosing a “brand” that the particular contractor trusts.<sup>15</sup> A consumer buyer may, for example, may request that a hypothetical “Consumer Reports” version of a washing machine purchase be used in the transaction, while the seller could hold out for a hypothetical “Chamber of Commerce” version of an agreement. Licensing parties could ultimately have a choice among many competing brands concerning software use, for

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<sup>15</sup> These phrases may be typically protected or complemented by the brand and goodwill of the certification marks that represent and control the quality of the usages of these expressions in cartons and packaging.

example, with varying degrees of collaboration or control that they promote. We do not know which party would prevail in the contest above between using the Consumer Reports, or the chamber of Commerce brand. Perhaps the parties would have to agree on a third brand, like a hypothetical “Fair Trade” brand; but at least the bargaining would be real.

As things stand now, many contracts are largely dictated by the more powerful party, taking the form of a standardized agreement that neither party reads or understands. Even in the most mundane and simplified transactions, communication of contract terms is often done through textual details.<sup>16</sup> Branded contracts become drastically simplified in the minds of the negotiators, because the “visible” portions of the contract may be reduced to a highly symbolic and visual icon plus a few specifics like price, quantity, and delivery dates. All of the other terms would be accessible “behind” the icon, probably on the community drafter’s website. *Hence a real choice could be restored to many transactions that currently lack choice. This form of bargaining could be highly efficient, and need not add significant transaction costs.*

In the sections that follow we describe and offer examples of the growing phenomenon of branded licensing, which seems the leading edge of a possible broader branded contract innovation. In this description of how branded licensing evolved and now serves the IP community, we suggest a categorization among types as “community-based,” “drafter-based,” and “industry associations.” We will then analyze the potential dangers as well as benefits of the practices of branded licensing.

Tying the paper into the overall topic of flexibility in contracting, we will conclude that branded contracting greatly promotes flexibility by giving contract users a range of efficient, accessible contracting options based on terms that predictably reflect the values of contracting parties--rather than employing either one-size-fits-all standardized agreements, or default state legal rules. Branded licensing and branded contracting offer potentials for introducing flexibility without sacrificing stability; for preserving efficiency through competition, as brands could compete with one another for adoption (and potentially fees); and for finding a more equitable distributional balance by reducing somewhat the needed sophistication involved in contracting.

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<sup>16</sup> For further discussion on visual communication of contract terms, *see* in this volume Barton Thomas D., Haapio Helena, and Borisova Tatiana, *Flexibility and Stability in Contracts*.

### 3. Branded Licensing of Intellectual Property

#### 3.1. *Introduction to Chapter 3*

Branded contracting may be on the horizon, inspired in part by the various “community” practices among intellectual property creators and licensees as described in this Part III. The vision for possible branded contracts outlined above has been largely from the perspective of those who *use* contracts in either consumer or business settings—the potential adopters of a particular “brand” of contract. In Part III, by contrast, we describe the history of branded IP licensing largely through the eyes of the communities that *created* the brands. To extend the analogy suggested above, we now consider branded agreements from the perspective of those who produce and distribute the eggs rather than those who might buy them. Described below are examples of how various communities came to define and protect the meaning of labels like “free range” and “organic” that appear on the cartons—and even regulate how the eggs might be eaten.

Considering the perspectives of both brand creators and brand adopters is essential for understanding and assessing the prospects and the potential limitations of branded contracting that will be considered in Part IV and the Conclusion of this article. As will become apparent below, the communities that have created branded IP licensing are doing far more than selling a product. Although they diverge in their origins and motivations, they are creating meanings and community identity, and may be furthering a world outlook. As a result, the relationship between a drafter and a user of a branded license may be more complex and interactive than in a typical commercial transaction.

#### 3.2. *Background*

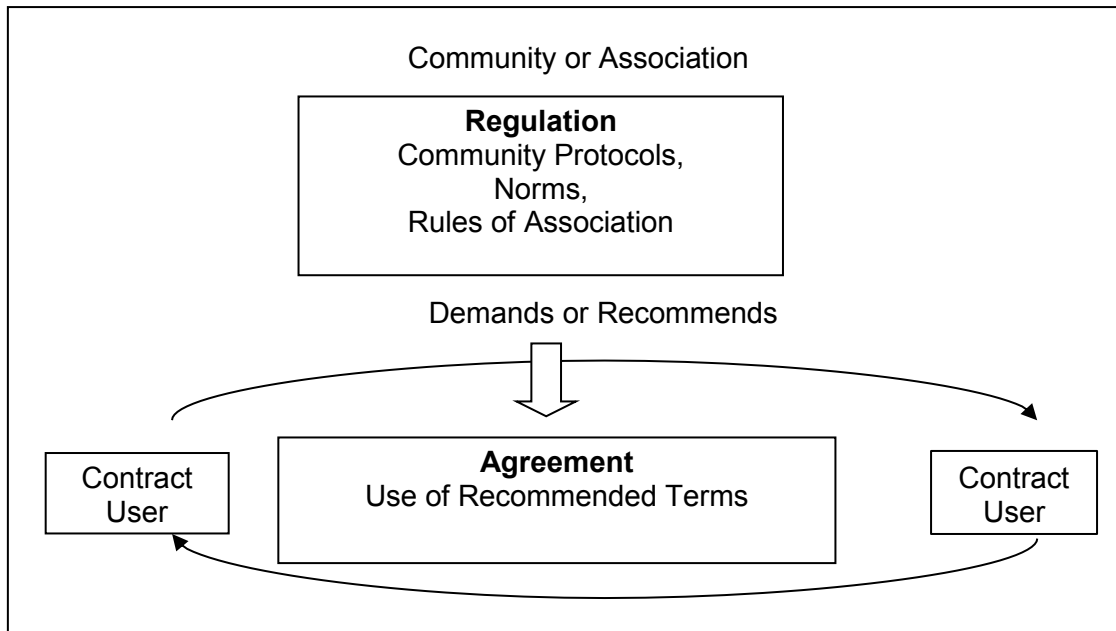
As the complexity of Intellectual Property (“IP”) law has grown, contracts have become increasingly important regulators for using, sharing and restricting IP both within and outside of the professional creator community. The contents and processes of contracts dealing with IP matters have become correspondingly more complex and challenging. Users and creators of digital contents must comply with various laws, and permissions must be sought, as

preconditions to most creative collaboration. This creates a need for both the users and producers to navigate the complexities of licensing terms and laws that are applicable to particular transactions. Both “standardized contracts” and “branded” practices arise out of this need. Standardized terms are far more common, and may be thought of as precursors to the branded approach. Either way, IP law requires that the contracts specify what types of actions can and cannot be taken regarding a particular expression, creation, or technological idea. Further, the scope of a right provided by IPR laws is not clear until the specific right is challenged and litigated in the courts. If one is to draft a contract in a proactive manner, due consideration must be given to all types of authorized actions and their combinations.

### *3.3. Standardized Terms, Model Terms and Reputation*

Using standardized terms, or a model contract that a professional association recommends, is nothing new. Standardized terms have been used often in mass market contexts. Likewise, use of model clauses or terms recommended by a certain professional organization is nothing new. In many businesses where transactions are repeated, or if both of the contracting parties belong to a certain professional organization, starting a contract negotiation based on a model terms often saves time and drafting costs for both parties. The relationship of the immediate contracting (licensing) parties to the recommending association or community is illustrated by Figure 1.

The reputation of the organization that drafts the model or standard terms is essential to professional organizations or reputable communities using these terms. With the drafting organization’s reputation and goodwill in the background, these practices gradually develop into branded contracting practices. Standardized terms provided by some professional associations such as the ICC (International Chamber of Commerce) or ORGALIME (European Engineering Industries Association) are used voluntarily, based on the reputation of the organizations. They may evolve into standardized practice by frequency of use. Standardized terms may be promoted by adoption of a template or a model contract that these professional associations draft.



[Figure1. Standard Terms – Community or Association Based]

In other contexts where templates or model contracts are not used, some of the standardized terms are promoted through the membership agreement among the members of the professional organizations. A good example is the licensing principle based on the FRAND (“fair, reasonable and non-discriminatory”) condition in information technology standard-setting organizations and the communication technology sector. They may become standardized through their voluntary use or mandated through membership. Because of wide reaching membership or because of the intended function of an organization as providing standardization within an industry, the terms of the agreement that the organization recommends can gain informal or formal authority.

### 3.4. *Branded IPR Licensing*

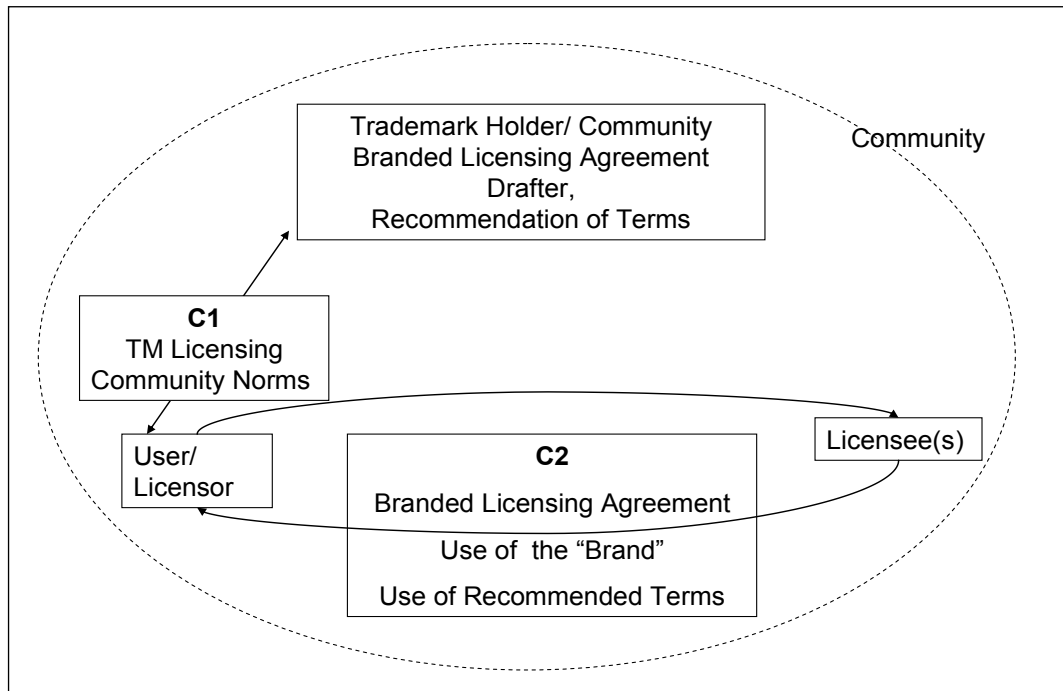
In contrast to the recommendations by associations, informal standardization of contract terms may occur by more spontaneous paths. A set of terms may simply be perceived as efficient by those working in a particular context. If used often enough, these like-minded people may create a community of users of such terms. This usage may be formalized through creation of a “brand,” or identity-signifying source. They may even be protected through a trademark. The emergence of this identity, in which people come to associate (and

trust) a third-party community with representing values or outlooks on the world that they share, is what enables the possibility of branded contracting, as distinct from standardized contracts.

In short, branded IP licensing describes a practice in IPR licensing of digital contents in which a mark, sign, word or a symbol is associated with the standard terms or meanings that are recommended to be used. It is controlled, in the sense that the terms of use are not drafted by the licensor but rather by another party or entity which has proprietary or other interests in the propagation of the terms of use. Thus a branded IP licensing seems to be a combination of flexibility with efficient standardization.

What sets branded contracting or licensing apart from use of the standardized terms of an association is the way in which the terms of the contracts are communicated to the users of the contracts – *visually*, *textually* and also *technically*. The parties will use a symbol or trademark of a certain “brand” of licensing to communicate core aspects of the contract content but also through textual contract terms. The resulting contract *need not visually include all of the terms that will actually govern their relationship*. The content is incorporated by an iconic reference—the symbol or trademark of the brand chosen by the parties. Importantly, this background content of specific terms or meanings is intended legally to govern the relationship. Additionally, contract contents may also be communicated through software tools so that the users may implement the terms of contract technically. Behind the trademark or icon is a community—a community either created especially for the purpose of governing licenses of certain IP, or a community that has arisen for other purposes but whose members have taken on the task of generating a set of licensing terms that reflect the ideology or values of that community.



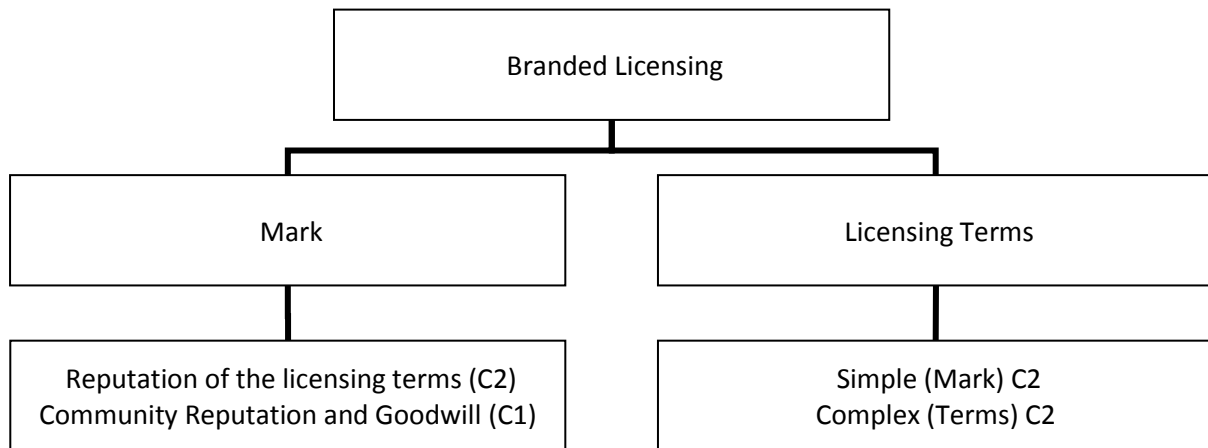


[Figure 2. A branded IPR license]

As Figure 2 shows, a formal branded licensing often has a two-fold structure. It involves two sets of usage and licensing terms: first the standard licensing terms that will govern the IPR relationship of the immediately contracting parties, i.e. the users (C2); but secondly, a set of terms that regulate the use of the mark and content of the community whose branded licensing terms have been employed by those parties, i.e. between drafter community organization and the user (C1). Hence, a branded licensing communicates two different types of information to the users of the standardized terms: (1) information on the terms and what can be expected of and by the parties to the license (C2); and (2) information concerning the reputation of the community that is behind the brand that the mark represents (C1). Agreement to the specific terms of the contract is dictated by agreeing to the licensing norms of the background community.

Furthermore, as Figure 3 below shows, the information on the specific terms that will govern the parties is given at two levels – a simplified version represented through iconic reference to a mark, and the more complex information representing the contents of the third party licensing terms (which may be available only at a third party website, rather than appearing in the particular licensing document). As to the reputation of the community behind the brand, that is far more general and perhaps under-articulated. But it is nonetheless real: branded licensing reflects the values that each “branding” community represents. Just as a contract

with a known company would carry a sense of the company’s image and business goals, a branded licensing conveys the norms and values of a community that drafted the terms of licenses. Thus, the trademark for the symbol represents not only the terms of the contract but also carries with it qualitative information about the community, i.e. the good will, just as a trademark for a goods or service is tied to the quality and the goodwill of the business.



[Figure 3. The Two-Fold Structure of Branded Licensing]

### 3.5. *Branded IPR licenses – Practice Survey*

Branded IPR licensing practices may be categorized into three different types: 1. “pure” user-community drafted; 2. mark-holder drafted; and 3. industry association drafted. Each involves different levels of brand usage and may be exclusively applicable to particular species of IPR.

#### 3.5.1. *“Pure” Community Based “Branded” Licensing – the OSI example*

In the “pure” community example, a pre-existing group formed for broader purposes may develop a shared consensus concerning certain norms about licensing, or some aspect of contractual exchange in which the members of the community engage. The “brand” that emerges may or may not be represented by a trademark, but outsiders who share similar

normative beliefs may adopt the licensing terms of the community group by referencing the group's work. In this model, the brand is more of a byproduct of the group's central activities, or a way for their members to gain control over certain usages that are crucial to their outlook. Eventually, general public adoption of the key terms may be possible. If that occurs, the branding community has in effect acted as a lobbyist or broader voice for certain values.

This sort of branded community may suggest specific terms, or may instead specify a framework or set of criteria that must be met for the organization to approve a particular agreement drafted by outsiders and permit use of the community mark. Such an "approval" rather than "specification" system permits greater flexibility to the particular contracting parties.

The "Open Source Initiative" [OSI] serves as an example of the pure community model. Open source licensing of computer programs has been growing steadily as an alternative means of distributing software. As a movement, it was originally formed around the crucial sentiments against distributing software in a "closed" source code. Where the source code is closed, the creators of the software are operating in a Permission mode. They want to control access to their idea, thinking that only by enclosing and selling or renting the ideas will they be able to ensure a return on investment. Collaborationists oppose that mentality, on grounds that without knowing the source code, it is much more difficult to build on the software. The sophistication and techniques of the software may be masked, and potentially alternative uses may be stifled. When both the user and producer community share a belief in open sourcing, the source code is disclosed or made accessible when the software products are distributed.

The OSI organization was formed to standardize the usage of the term "Open" through the usage of a mark of approval ("OSI Approved") to a set of licensing terms that meets the standards of the OSI. OSI reviews and approves license terms according to their standards. To bear the mark, the approved licenses *need to include a certain set of conditions* in the license agreement that meet the core meaning of an open source.<sup>17</sup>

In addition, to use its trade mark and logo, the OSI website specifies that the user must

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<sup>17</sup> <http://www.opensource.org/docs/osd>

comply with the trademark and logo usage guidelines.<sup>18</sup> These guidelines aim to ensure that only those software licensing practices which meet the requirement of the definition of “open source” of OSI will be allowed formal use of the OSI logo.

In the OSI example, the standardization of licensing terms is preceded by the evolution of community norms. Use of the OSI logo becomes an additional way of branding the open source community. In other words, the norm of open source licensing was achieved prior to the actual standardization of the terms and trademark usage policies. The brand is organically formed, based on community norms among the users. The specific open source licensing terms are simply codifications of those informal norms, and the trademark and logo usage guidelines enforce such codified norms.

Users of open source licensing forms are often aware of the implications of using the OSI terms. On the other hand, the original OSI movement grew out of a common yet uncontrolled understanding of “openness.” The degree of “openness” was, and remains, controversial. For that reason, it was necessary to generate a common means to control the flow of the open source code programs, and to standardize the use of the phrase “open source code” when code was actually distributed.

This necessity seems to apply not only the first generation open source code products, but also the second generation products. Second generation products may be a mixture of both open and close source code product, and if so it is important to determine how much code is actually subject to the open source licensing. Diverse licenses may claim to be “open,” in other words, but may fail to meet the original expectation of the open source community. The use of the certification mark is one means of OSI’s attempt to enforce and control the various versions of the open source licensing that are currently in use. Through standardizing core terms and then tying such usage to the certification mark and logo, OSI standardizes open source licensing through branding. Further, approval by OSI is a way of lending normative authority to the terms through the community, even while the specific licensing terms are drafted by the parties to the agreement.

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<sup>18</sup> <http://opensource.org/trademark-guidelines>

### 3.5.2. *Industry Association or Facilitator Drafted Branded Licensing*

Under this model, the community behind the brand maintains selective membership, and only members or buyers of the association's services have access to their brand of contracts or licenses. Mass adoption of the terms by the public is not the intention, and may not even be permitted. In certain contexts, these general terms or contracts are sold as templates in the particular industry. The European Engineering Industries Association's "ORGALIME" contracts, which pertain to tangible objects rather than IPR, are an example. In the engineering industry, the terms and general conditions of known and reliable industry associations are used often as standard terms, and are sometimes referred to as "soft law."<sup>19</sup>

Within the IPR context, these tendencies are visible in collective IPR management, notably in patent pools for technological standards. Patent pooling essentially creates a community that has been formed purely for the purpose of cross-licensing, or to set licensing principles or recommendations to achieve that goal. Examples of such a closed community brand may be standard setting organizations such as the Organization for the Advancement of Structured Information Standards (OASIS) consortium,<sup>20</sup> and the World Wide Web Consortium (W3C).<sup>21</sup> Members of the Consortium participate in the standard setting activities and in return agree to comply with core licensing principles. OASIS, for example, requires members to grant licenses on Reasonable And Non-Discriminatory terms (RAND) and to use Royalty Free (RF) terms or other conditions.<sup>22</sup> W3C similarly promotes its patent policy,<sup>23</sup> and through its Community Contributor Licensing Agreement (CLA) imposes on its members an obligation to use RF terms on the standards that they contribute.<sup>24</sup>

Industry association branding is similar to the OSI initiative in the sense that the brands of the OASIS and the W3C are closely linked with the ideology of open standards. They

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<sup>19</sup> Whittaker Simon, *On the Development of European Standard Contract Terms*, 2.1 EUROPEAN REVIEW OF CONTRACT LAW 51 (2006).

<sup>20</sup> The OASIS consortium is a non-profit consortium that promotes industry standards for security, Cloud computing, SOA, Web services, the Smart Grid, electronic publishing, emergency management, and other areas. <https://www.oasis-open.org/standards>

<sup>21</sup> W3C is the World Wide Web Consortium that develops open standards to ensure the long-term growth of the Web and promote open standards principle. See their website for detail, [www.w3c.org](http://www.w3c.org)

<sup>22</sup> For OASIS licensing requirements, see [https://www.oasis-open.org/policies-guidelines/ipr#licensing\\_req](https://www.oasis-open.org/policies-guidelines/ipr#licensing_req) at §10 *et seq.*

<sup>23</sup> <http://www.w3.org/Consortium/Patent-Policy-20040205/>

<sup>24</sup> <http://www.w3.org/community/about/agreements/cla/>

recommend core licensing terms and conditions for standards specifications developed under the Consortium. These Consortium licensing agreements depend greatly on voluntary adoption by the users (members) of the licensing agreement. Further, the background content of the standard “brand” of OASIS<sup>25</sup> and W3C are known, but use of the sign is for the members only. However, unlike OSI, they do not have licensing terms approval process or a certification program.

This type of “branded” licensing would not lead to a strong standardized contract, but only standardization of the principles to be used in drafting the licensing agreement. The brand represents and informs that certain licensing principles are adopted. The brand, however, does not fully stand in as the visually represented part of the contract.

Further, these industry association practices need to be distinguished from the practices of facilitator drafted licensing. An example of this would be the W-CDMA (Wideband Code Division Multiple Access) patent pool for interface standards in 3G mobile telecommunication network products. The patent pool grouped together all relevant W-CDMA FDD standard essential patents from those companies joining the program, and coupled them within the licensing program. Currently the licensing program is administrated by Sipro Lab Telecom which provides licensing programs for telecommunications technologies, including “3GPP W-CDMA FDD Standard and ITU-T G.729, G.723.1, G.729.1 and G.711.1 recommendations for speech and audio coding”.<sup>26</sup> In this case, a license administrator drafts the agreement and facilitates use by the IPR holders; thus licensing terms are indirectly standardized. They are facilitating licensing, and establish only a vehicle to pool the rights. Thus they fail to form the basis of a “branded” licensing practice as analyzed in this chapter.

### *3.5.3. Drafter Based “Branded” Licensing – the Creative Commons Example*

In contrast to the pure or organic community model exemplified by OSI approved licenses, or the model of OASIS or W3C whereby a licensing principle rather than the terms are standardized, there is a third model of branded licensing. Some community or organization drafted licenses may strictly control the uses of the license terms by providing not simply a

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<sup>25</sup> <https://www.oasis-open.org/private/logos.php>

<sup>26</sup> [http://www.sipro.com/wcdma\\_about.php](http://www.sipro.com/wcdma_about.php)

model set of terms, but also extensive legal documents that the users need to adopt. In other words, use of a mark signifies not simply approval of terms that may be generated by the particular parties, or the core licensing principles, according to the brand of the community or associations. Instead, the mark further entails that the parties adopt particular language of the branded organization and contract terms.

In this model, the iconic references simplify and standardize the contracting process, but at the expense of level of freedom of the particularly contracting parties. Particular parties must adopt the texts that the organization provides, even though some level of choice may be maintained by the brand offering different modules of licensing terms. Regardless of the variety of modules available, here the brand is created so that a community can be created through collective usage of the branded terms. The brand forms a key core of the idea of the community, rather than an offshoot of other activities, and the use of the brand is crucial. General public adoption of the key terms may well be the explicit goal of the branded community.

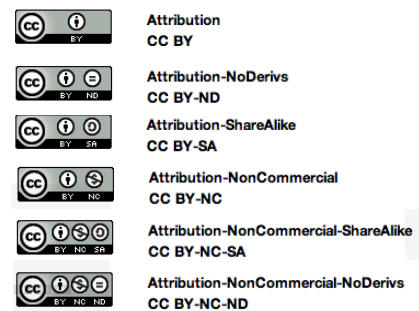
One good example of brander-drafted contracts is Creative Commons. Creative Commons is a movement that was first initiated by Lawrence Lessig as an explicit reaction to Permission-style closed and “all rights reserved” copyright licenses whereby right holders reserve all rights to the copyrighted contents. A license granted under this Permission model has an inflexible and unitary character that disenfranchises a user of the contents; users are relegated to the role of mere passive receiver of contents, with broad restrictions in their use of the work. Under such terms, creative and transformative uses that would otherwise be allowed under the law may be prohibited through contracts.

“All rights reserved” restrictive licenses seem to reflect a fear of an uncontrolled future such as we have analyzed as one source of contract inflexibility. The concern is that more lenient licensing conditions could lead to the loss of rights and future profitable use of the works. The result, however, is a rigid, complex contract that reserves rights in an attempt to restrict or eliminate that possible future. Creative Commons starts from a more flexible premise: that the right holders may grant a “*some* rights reserved” license that protects future profitable commercial uses of the works for the right holders, but without the complexity of “all rights reserved” contracts.

Each Creative Commons license is explained and available in three different forms in what they call three layers directed at different readers – the general public (“human readable”); computers (“machine readable”); and the actual license terms (“lawyer readable”). Aside from the obvious joke that the lawyers are not human, each layer explains the same licensing terms in ways that are simple (“human readable”), codable (“machine readable”), or legally binding.

Users of the license are also guided through easily understandable questionnaires that aim to help the users select the correct license. The current versions (3.0) of the Creative Commons licenses have the following features (overleaf), with shorthand information attached to each of them:

- “(1) Attribution 3.0,
- (2) Attribution-NoDerivs 3.0
- (3) Attribution-ShareAlike 3.0
- (4) Attribution-NonCommercial 3.0
- (5) Attribution-NonCommercial-NoDerivs 3.0, and
- (6) Attribution-NonCommercial-ShareAlike 3.0”



[Figure 4. Types of Creative Commons Licenses]<sup>27</sup>.

The understanding that a license may be at once Collaborative and Permission-oriented forms the legal and normative core of Creative Commons. While acknowledging that an intellectual “commons” may be constructed through private licenses, normatively Creative Commons seeks to create a less Permission-based and more Collaborative basis for sharing copyrighted contents.

### 3.6. *Theory: Branded Licensing or Contracting as Movement to a “Semi-Commons”*

Community based branded licensing or contracting has theoretical implications for understanding both property and contracts. In the IPR context, branded licensing converts IP

<sup>27</sup> <http://creativecommons.org/licenses/>



to a kind of intellectual commons that is subject to a set of entry rules. Rather than a single enclosure “owner” who dispenses individualized entry Permissions, and rather than a fully Collaboratively shared commons, branded licensing creates a subunit of community and commons that allows Collaborative usage, but *only for the members of the community, and only according to particular rules.*

The term “commons” as used in the branded licensing context is only a metaphor. The resources of a branded community are not actually and legally held in a commons; rather they are an aggregation of private rights where the right holders choose not to exercise their rights, or have granted rights of use to the members of the entire community. In a strict sense, even the “pure community” based branded licensing cannot create a positive commons arrangement. A true “positive commons” would require a single and uniform right over the common pool of resources to be created and communally held, and where any additional use of the resources would thus require consent from each member of the community.<sup>28</sup> Such individualized consent is infeasible for any large commons. But we note that in a modern democratic society, intellectual property law created through a legitimate legislative process can be understood as a sort of proxy for gathering consents from all of the members of the community.

A “negative” commons, in contrast, would be one in which no resources are understood as being subject to initial commonly held entitlement. Resources are instead available to be captured, and then brought under private property ownership without seeking any consent or approval. In the intellectual property realm, a negative commons would be a regime in which individual intellectual property right could be claimed over all previously unclaimed intellectual creations and innovations. In a negative commons, there would be no such idea as “the public domain” where no rights may be asserted.

Both positive and negative commons fail to describe accurately the commons that the

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<sup>28</sup> A resource that is initially owned by no-one, so that individual use depends on no-one’s consent, is a “negative” commons. If ownership is shared by a community and individual use depends on the consent of all, that is a “positive” commons. We use the concept of positive commons as distinguished from negative common as it appeared first in Drahos Peter, *A PHILOSOPHY OF INTELLECTUAL PROPERTY* (1996). See also Drahos Peter, *Freedom and Diversity: A Defence of the Intellectual Commons*, in Reddy P. L. Jayanthi, *CREATIVE COMMONS: INTERNATIONAL PERSPECTIVES* 50-57 (2008). For similar concepts see Benkler Yochai, *The Political Economy of Commons*, 4.3 *THE EUROPEAN JOURNAL FOR THE INFORMATICS PROFESSIONAL* 6 (2003).

branded licensing aims to promote. If positive commons is an ideal of how property regimes of intellectual resources should be arranged based on the original position that all knowledge is part of a community, then negative commons is actually a more accurate description of the current system of intellectual property rights.

A better analogy for the commons of the branded community might be a “semi-commons:” the resources of a club or gated community, in which the entry fee is the agreement to use only a particular type of licensing. Essentially, the branded community moves consensually from protecting IPR strictly by Permission, to a mid-way point between Permission and Collaborative models. Thus it comes close to the protection of IPR through “liability rules” in which anyone may have access to the resource so long as they pay the property owner a form of compensation (which here may be advancement of the point of view or values of the drafting or approving community).<sup>29</sup>

Converting the ideal of intellectual commons into a Permission-based gated community or club may create both an ideological and a theoretical dilemma. An intellectual commons as a positive commons includes all of the community members. No community members may require permission from each other to use the resource, as every member of the community already possesses the right of use as a right holder of the commons. In contrast, any person who takes a resource out of the commons to create an individual right would need a consent from the community. By gating the community, a Permission quality is inherently added to the Collaborative commons, regardless of how liberally the permission is given. Thus the norm of property arrangement, at least to this extent, changes from positive commons to negative commons. Subjecting the intellectual commons to licensing requirements means that private rights become the norm. The subject matter under these pooled commons is, in principle, subject to private appropriation and any unclaimed subject matters are considered *res nullius*, which may be claimed. If the goal is the creation of non-propertized commons, creation of gated community falls short. It may create open access, but that access is nonetheless based on propertization and Permission.<sup>30</sup>

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<sup>29</sup> Calabresi, *supra* note 2, applied by Reichman in Reichman Jerome H., *Of Green Tulips and Legal Kudzu: Repackaging Rights in Subpatentable Innovation*, 53 VANDERBILT LAW REVIEW 1743 (2000); for its importance in contracting, see Merges, Robert P. *Contracting into Liability Rules: Intellectual Property Rights and Collective Rights Organizations*, 84 *California Law Review* 1293 (1996).

<sup>30</sup> Elkin-Koren Niva, *What Contracts Cannot Do: The Limits of Private Ordering in Facilitating a Creative Commons*, 74 FORDHAM LAW REVIEW 375 (2005).

On the other hand, since an intellectual commons or information commons presupposes the concept of community, creation of an IPR club as a community may realistically provide the precondition for creating a small scale intellectual commons that is subject to (and encourages) sharing. A sustainable commons regime has preconditions, one of which is satisfied by the gated community analogy: a tightly knit community where the boundary, use, measurement, and members entry to the commons is closely monitored, and regulated by well understood norms.<sup>31</sup>

Not all branded licensing “clubs” create such a community of common values. The OSI pure community model is the strongest candidate. This community develops well understood norms, and the members participate in the drafting of the terms of licensing agreements as well as use them. This IP club is closer to the small scale commons. The “brand” of this community may be controlled and well understood by the users as part of broader norms. But when those terms are used outside of the drafting community, those broader community norms may be disregarded or break down. At that point the IP club becomes exactly what it is – a club.

The second type of branded community—the drafter based organization like Creative Commons--follows the opposite course of action. Since the contract terms are drafted for the very purpose of *creating* a community, it is only in the use of the terms—the “initiation” --that membership is created. The community is the licensing terms themselves. The only condition to entry is the requirement to use the terms of the IP club. No separate set of norms guides the behavior of the members of the community; its users (and hence members) have diverse various interests and motivations for being part of this community. If open source code is the code of ethics for the community for OSI, not all users of Creative Commons have common coherent norms before they start to use the license. When the license is used, however, a community norm of “some rights are reserved” is formed since none of the Creative Commons licenses allow users to reserve all aspects of copyright.

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<sup>31</sup> See Hess Charlotte & Ostrom Elinor, *Ideas, Artifacts, and Facilities: Information as a Common-pool Resource*, 66 LAW AND CONTEMPORARY PROBLEMS 111 (2003). See also Reichman Jerome H. & Franklin Jonathan A., *Privately Legislated Intellectual Property Rights: Reconciling Freedom of Contract with Public Good Uses of Information*, 147 UNIVERSITY OF PENNSYLVANIA LAW REVIEW 875 (1999); Rose Carol M., *Expanding the Choices for the Global Commons: Comparing Newfangled Tradable Allowance Schemes to Old-fashioned Common Property Regimes*, 10 DUKE ENVIRONMENTAL LAW & POLICY FORUM 45 (1999).

As a result, errors in matching the contract terms with the intended usage are unavoidable, since the users of the terms likely had no part of their drafting. They also share no prior common normative understanding. Furthermore, if the mark that is associated with the licensing term is such that it creates a separate meaning beyond the licensing terms, this in turn will lead to more confusion. Just as confusion or disappointment is generated in a consumer when the good will that a trademark represents does not match the product quality, mismatching of the licensing terms and the brand will create confusion and disappointment. The possibility of the mismatch increases if the users do not fully comprehend the norms of community that the licensing agreements aim to create or respect. But there is no other source for such norms than the licensing terms themselves: the norms of behavior in the potential community can only come from the terms of licensing agreement itself.

#### 4. Benefits and Challenges of Branded Licensing or Contracting

##### 4.1. *Benefits*

Branded licensing promises much of the economic efficiency gained through standardization, but with less of the adhesive contract qualities. Branding allows users to bargain realistically about the type of contract they wish to use, based on the templates. The templates provide reduced complexity and easy access to the materials, which serves many functions. Management, or even consumers, can be brought into the contracting process at a much higher level of engagement, while keeping transaction costs low.

Sellers as well as buyers can gain from the efficiencies and choices made available by branding. In the case of licensing, for example, the branding tools can enable easy agreements about distribution of IPR materials. This is a distinct advantage, for example, to firms that provide services that allow users to distribute their contents on the Internet (such as YouTube or Flickr). Those firms benefit if the process of gaining permission and distributing can be so simple that even those who use mobile phones or Blackberry can easily attach contract terms when they share their contents and media files.

Branded licensing may also transcend a traditional dilemma faced by contract drafters: the

tension between simplicity of terms and attention to legal detail. Although many (rightly) call for contracts to be written in more accessible ways, if those efforts result in *overly* simplifying the legal contents of an exchange or relationship, other problems are created. Simplification in contracting is therefore often viewed with caution. Although simplified information is useful to manage the complexities in contract terms, the fine print in contracts often safeguards important risks and may create significant obligations that cannot be ignored.

There seems a genuine trend to remove unnecessary complexities from IPR licensing and other contract documents.<sup>32</sup> In e-Commerce and mobile commerce, the need to simplify contract terms in a visual manner seems to be felt more urgently, both in commercial as well as consumer contracts.<sup>33</sup> On the other hand, to function as a valid and useful form of contract, most contracts for innovation need to provide an adequate level of certainty for both parties to the contract. The beauty of branded contracting is that even though the contract is simplified from the *user* perspective, from the *legal* perspective it can continue to be fully inclusive and detailed. The documents behind the mark or sign can be comprehensive, although as discussed below the more sophisticated those background documents, the more dependent branded contracting is on maintaining trust between the drafters at the branding community and those who ultimately adopt the brand for use in their contracts.

## 4.2. Challenges

### 4.2.1. Evolution of Meaning

One of the challenges of branded contracting lies with the fact that a “brand” may end up misleading the users of the licensing. As with the standardized consumer contract of

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<sup>32</sup> For example, a lean contracting or a “pathclearer” approach represents some of these trends. For an agenda for lean contracting, see IACCM, *LEAN CONTRACTING: What Might It Look Like And Why Does It Matter?* IACCM November News Letter (2006), available online <http://www.iaccm.com/news/contractingexcellence/?storyid=289>, last accessed 28 June 2013. For a pathclearer approach, see, e.g., Weatherley Steven (2012), *Pathclearer and Legal Risk Mapping: Cutting through the Contract Jungle*, available online <http://plc.practicallaw.com/0-519-1805>, last accessed 28 June 2013.

<sup>33</sup> Henschel Rene F. & Cleff E.B., *Information requirements and consumer protection in future M-commerce: textual information overload or alternative regulation and communication?* INTERNATIONAL JOURNAL OF INTERCULTURAL INFORMATION MANAGEMENT 58 (2007).

adhesion, a branded licensing is meant to be used in mass and thus is directed to a general audience or a large subset of the public like “technology users.” A brand is represented by a trademark or sign that distinctively designates or represents the quality of a product or a service. These signs could create confusion unless users can adequately understand from the signs or marks what the underlying terms of usage will say or the level of protection they will provide.<sup>34</sup> Yet marks or signs can evolve in their meaning or social perception. Through usage, a mark or a sign may acquire other meanings beyond their original function that may originally have notified or informed the consumer. Such evolution may be positive, especially if it represents improvements in tangible products or services. Or the evolution may be negative, either by degrading the quality from what was previously connoted by the brand or by creating legal confusion.

A related problem could arise from “version control.” Different versions of licensing terms, for example, are inevitable in a dynamic industry like software development or in any industry that may need to take different user segments into account. The users of a licensing agreement, for example, may have different needs regarding permission for commercial uses, research uses, or simply for private uses made in public, like blog posts. Furthermore, users may be segmented into different geographical jurisdictions, especially in IP where there are no uniform transnational laws that govern all transactions in a given item. Some terms will need to be adjusted to different local laws, beyond a simple linguistic translation.

#### 4.2.2. *Trust*

Finally, the generalized issue of trust should be emphasized: branded licensing or contracting will work only as well as contracting parties trust that their basic interests are well represented or protected by the terms drafted by individuals associated with a particular brand. As suggested above, the more detailed and comprehensive those background documents, the more vital is the trust between the branding community and those who choose to use the brand. Making this even more difficult is that to be commercially viable, the brand will very likely employ a general disclaimer that insulates the brand from liability for deals that somehow go bad among users who adopt and use the branded contract. Were the brand

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<sup>34</sup> See, e.g., *Chang v. Virgin Mobile USA, LLC*, 2009 WL 111570 (N.D.Tex. January 16, 2009) (Flickr photograph of a minor, using a CC Attribution license which fundamentally allows commercial use, but which did not address the issues of privacy of the subject of the photograph).

to be required to examine the efficacy of transactions, or even to monitor how the brand clauses are interpreted in the hands of various users, much of the economic efficiency of branded contracting would disappear. Hence prospective users of a brand would no doubt encounter a significant disclaimer from the branding community just at the time that the user is being asked to trust that the brand community is in solidarity with the users' interests.

How can this trust be created and preserved, especially in the many contexts in which users will not necessarily have any creative or formulating connection to the community that created the brand? As a brand develops it may go in directions that seem a betrayal to groups that may previously have endorsed the use of a brand and has formed the community. Norms that did not pre-exist start to form, creating expectations from the community of the users. For example, when Creative Commons issued CC license version 2, the Free Software Foundation denounced the terms and discontinued their support for the Creative Commons community.<sup>35</sup>

## 5. Conclusion

Communities of every sort face the possibility that their resources will be abused. In response, they may follow either a Permission-based or Collaborative approach. Those who fear exploitation or a corruption of community resources or values through open use will feel a strong impulse toward Permission culture. Those who see outsider adoption of their community resources or outlook as opportunities for growth and development will lean toward Collaborative culture. Branded licensing or contracting offers the possibility of melding aspects of both approaches, in different mixtures that may suit different communities. The idea is broad enough to appeal to communities with different histories and goals. The terms by which a community may permit use of its trademark or sign, and of its underlying contract documents, should be thoughtfully considered within the community.

So also, companies adopting any of these models of branded contracting need to assess carefully why certain pre-existing branded terms are to be preferred over others, and whether the norms of the branding community should be supported. Companies must remain mindful

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<sup>35</sup> Stallman Richard M., *Fireworks in Montreal*, FSF Blogs, (2005), available online < <http://www.fsf.org/blogs/rms/entry-20050920.html> >, last accessed 28.June 2013.

that the drafters of the contract will likely not be liable for negative consequences from the use of their contracts. They must also remember that the contract contents will evolve through new versions--and possibly changing values--at the branding community. Finally, companies should be aware that decisions between competing brands could have symbolic, cultural, and goodwill effects at the adopting company, as well as legal and business consequences. With all that said, however, branded contracting may have an iconic future.

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Website <http://creativecommons.org/licenses/>

Website <http://www.opensource.org/docs/osd>

Website [http://www.sipro.com/wcdma\\_about.php](http://www.sipro.com/wcdma_about.php)

*Promoting Contract Flexibility through Trademarks*

Website [https://www.oasis-open.org/policies-guidelines/ipr#licensing\\_req](https://www.oasis-open.org/policies-guidelines/ipr#licensing_req)

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