

The functions of contracts in interorganizational relationships: A contract experts' perspective

Abstract

Previous research has shown how contracts are used together with relational governance mechanisms to manage interorganizational relationships (IORs). Moreover, research has found that contracts are used in safeguarding, adapting, and coordinating business relationships. Based on the findings of an interview study with 24 contract experts, we argue that, in addition to safeguarding, adaptation, and coordination, firms use contracts to codify their deals; to steer their internal work; and to plan, promote, and steer collaboration. On one hand, when used intelligently, contractual techniques that reflect different functions can enhance IOR performance. On the other hand, the careless use of contracts can negatively affect relational governance and IOR performance. Our research has notable theoretical and managerial contributions, as it develops the theory of the functions of contracts and argues that the functions are fundamental to designing a contract that aims to complement relational governance and support IOR performance.

Keywords

contracts; relational governance; interorganizational relationship performance; contract expert; safeguarding; adaptation; coordination; codification; internal management; collaboration; functions of contracts

Disciplinary areas

Contract law, sociology of law

1. Introduction

Globalization and the fragmentation of production have led to changes in the organization of businesses in the new economy; firms tend to focus on their core business and outsource other functions (Baldwin and Martin, 1999). Consequently, in contrast to the 20th-century ideals of firms combatting each other on a battlefield, firms have become dependent on interorganizational relationships (IORs, Frydinger et al., 2016).

IORs are governed by formal governance mechanisms, namely, contracts, and relational governance mechanisms, such as trust and social norms (Dyer and Singh, 1998;¹ Poppo and Zenger, 2002). For a long time, these two governance mechanisms were seen as substitutes for each other. Moreover, relational governance mechanisms were regarded as the most effective means to govern an exchange relationship (see *inter alia* Dyer and Singh, 1998). More recently, however, contracts and relational governance mechanisms have been shown to complement each other (Cao and Lumineau, 2015; Poppo and Zenger, 2002).

Our starting point is that, to complement relational governance, contracts should be used *functionally* (see also Cao and Lumineau, 2015; Malhotra and Lumineau, 2011; Schepker et al., 2014). The functional approach acknowledges that contracts can be structured to serve many functions, such as safeguarding, coordination, and adaptation. This approach stands in contrast to the structural approach suggested by scholars of transaction cost economics (TCE), who view contracts as tools both for structuring optimal governance choices and for safeguarding parties' interests against opportunism (see, e.g., Schepker et al., 2014; Williamson, 1985).

An increasing number of researchers (Cao and Lumineau, 2015; Chen et al., 2018; Hofman et al., 2017; Lumineau and Malhotra, 2011; Malhotra and Lumineau, 2011; Mellewigt et al., 2012; Schepker et al., 2014; Wang et al., 2017) have adopted the functional approach to contracting. However, the approach has not yet engaged with existing research on the interplay between formal and relational governance mechanisms (for exceptions, see Cao and Lumineau 2015; Chen et al., 2018; Lumineau and Malhotra, 2011; Malhotra and Lumineau, 2011; Wang et al., 2017). Likewise, legal research has mainly been interested in dogmatic studies of the neoclassical contract law system, together with the structural approach to contracting noted above. Moreover, the management literature and legal research on contracts barely communicate with each other. Consequently, such scholars as Schepker et al. (2014: 216–218) and Cao and Lumineau (2015: 32) call for research that investigates how different functions of contracts and relational governance interact with each other. We furthermore believe that while legal scholars could greatly benefit from adopting the functional approach to contracting, they can also contribute to existing research in a number of ways (see also Smith and King, 2009: 2). First, because of their education, lawyers and legal scholars should have a complete understanding of the functions of contracts and their (legal) implications. Second, as the contract law system both reflects and affects the possibilities and the limits of contracts, it is important to understand the history and characteristics of the different views on contracts. Here, legal scholars have an important intermediary role.

In addition, existing research on the interplay between formal and relational governance is dominated by quantitative economic analyses. These analyses have undoubtedly advanced our understanding of different interfirm governance mechanisms, but there has nevertheless been a call for more qualitative research (see, e.g., Eigen, 2012: 301–302; Schepker et al., 2014). We agree that a qualitative research method affords an opportunity to acquire knowledge that cannot be accessed by quantitative methods. By conducting interviews with 24 contract experts, we aim to develop further the theory of the functions of contracts by constructing an interpretative generalization of typologies based on the experts' knowledge of and experience with contracts (Bogner and Menz, 2009: 48).

Thus, to fill the research gap on how the different functions of contracts interact with relational governance and to answer the call for more qualitative research, we designed the above-mentioned theory-generating expert interview study that focused on the relationships among relational governance, contracts, and IOR performance. The data comprised 23 semi-structured interviews with 24 contract experts. By analyzing the data thematically (Braun and Clarke, 2006), we aim to answer the following research questions in this article:

1. What are the functions by which companies use contracts to govern IORs?
2. How does a contract and its different functions affect relational governance (or vice versa) and IOR performance?

The results of our analysis indicate that first, in addition to safeguarding, adaptation, and coordination, firms use contracts to serve three other functions: codification, internal management, and collaboration. While the codification function refers to contractual techniques that put together and verbalize the deal for all parties, the internal management function, in turn, refers to contractual techniques aimed at steering the intrafirm work and processes and communicating the objectives and scope of the deal internally. Finally, the collaboration function refers to contractual techniques that support the creation and development of a collaborative IOR, characterized by a common vision, a common project organization, and a jointly developed project culture based on trust, communication, and commitment.

Second, our findings suggest that contracts affect relational governance and IOR performance both positively and negatively. On the one hand, contracts support IOR performance when they are clear and balanced. On the other, contracts can contradict relational governance and hinder IOR performance when they are one-sided or unfit for purpose. In the process, we also found that lawyers themselves could affect performance negatively by hindering negotiations, complicating contracts, or concentrating too much on safeguarding clauses. Based on these results, we argue that the functions of contracts are fundamental to designing a contract that aims to complement relational governance and support IOR performance.

Our study has important theoretical and practical contributions. On a theoretical level, our study further develops Schepker et al.'s (2014) analytical framework on the functions of contracts. On a practical level, the research provides managers and contract experts with guidelines to

plan their negotiations and contracting processes and to design contracts that complement relational governance and support IOR performance.

The rest of the article is structured as follows. In Section 2, we review research on interfirm governance mechanisms and functional approaches to contracting as much as it is relevant to our research questions, and we state the entry point of our research. In Section 3, we present our research design, methods, data, and analysis process. We then move to present our findings in Section 4. In Section 5, we first discuss our findings and then consider the limitations of our research and suggest ideas for future research.

2. Contracts, relational governance, and the functions of contracts

2.1 Contracts and relational governance as substitutes or complements?

Research on IORs has shown how they are governed both by formal governance mechanisms—namely, contracts—and by relational governance mechanisms that arise from the values and agreed-upon processes within a relationship (Poppo and Zenger, 2002: 709). Trust, solidarity, and flexibility are examples of relational governance methods (Lioliou et al., 2014: 505; Poppo and Zenger, 2002: 709–710).

For a long time, research on formal governance and relational governance focused mainly on the debate between the *substitution* and *complementary* views (for a comprehensive review, see Cao and Lumineau, 2015). According to studies supporting the substitution view, relational governance is seen as the most effective way to minimize transaction costs and maximize value-creation initiatives, whereas formal contracts are seen as costly and inflexible in governing value creation (Dyer and Singh, 1998: 760–671). Trust, for example, could substitute some elements of contracts, such as negotiated changes that could require the contract to be rewritten (Dyer, 1996; Dyer and Singh, 1998). These studies argue that the combined use of relational governance and formal contracts is fundamentally problematic and that formal contracts can even hinder the proper and functional use of relational governance structures (Dyer and Singh, 1998; Huber et al., 2013).²

Other studies, however, advance the argument that formal contracts and relational governance function as complements (see, e.g., Cao and Lumineau, 2015; Gil and Zanarone, 2017; Macaulay, 1963: 65; Poppo and Zenger, 2002) or that they can both substitute or complement each other, depending on different circumstances (Abdi and Aulakh, 2014; Cao and Lumineau, 2015). According to the complementary view, both governance mechanisms are seen as enabling mechanisms (Huber et al., 2013) and as compensating mechanisms. For example, as enablers, clear contracts facilitate the development of relational governance by increasing mutual confidence, reducing information asymmetry, improving a mutual understanding, and supporting trust. As compensators, in turn, contracts compensate for the limitations of relational governance (Cao and Lumineau, 2015: 11). The complementary view has been verified in various empirical studies and, thus, represents the prevailing view of the interplay between the two governance mechanisms (see, e.g., Abdi and Aulakh, 2014; Cao and Lumineau, 2015; Dyer and Chu, 2003; Gil and Zanarone, 2017; Hoetker and Mellewigt, 2009; Li et al., 2010; Mellewigt et al., 2012).

Recently, the focus of research has shifted from the dichotomous debate between the substitution/complementary roles of contracts and relational governance toward a more elaborated view concentrating on the different dimensions of contracts and relational governance, their mutual effects, and their joint effects on IOR performance (Cao and Lumineau, 2015; Schepker et al., 2014). This research, with a special focus on business studies and economics, as well as on legal research, is discussed next.

2.2 The functional approach to contracting

Economic research on contracts is still dominated by TCE, which approaches contracts structurally by highlighting their role as a means to structure optimal governance choices for transactions and to safeguard parties' interests. Schepker et al.'s (2014) review, however, shows how the focus of research has slowly shifted toward a broader view of the interplay between relational governance and contracts (see, e.g., Faems et al., 2008; Poppo and Zenger, 2002). This research recognizes, first, that contracts and relational governance are intertwined, forming complex governance combinations to manage business relationships and, second, that contracts can do more than simply safeguard the parties' interests. This approach is conceptualized as a functional approach to contracting by Schepker et al. (2014). In opposition to the structural approach, the functional approach proposes that safeguarding parties' interests is only one of the many functions of a contract (Schepker et al., 2014).

According to Schepker et al.'s classification (2014), when contracts are used functionally, they can, in addition to safeguarding, *coordinate* and *adapt* the relationship (e.g., Chen et al., 2018: 473; Lumineau, 2017; Lumineau and Malhotra, 2011; Reuer and Ariño, 2007; Schepker et al., 2014: 206; Schilke and Lumineau, 2018). The coordination function refers to contractual mechanisms that organize the relationship of the parties, tasks, and communication for the duration of the contract. Coordinative clauses include, inter alia, provisions for communication and monitoring (Schepker et al., 2014: 211). The adaptation function of a contract, in turn, refers to contractual techniques that are used to adapt the relationship in response to possible endogenous or exogenous changes. Examples of adaptive terms are price adjustment clauses, clauses on change management, force majeure clauses, and clauses on contract termination (Chen et al., 2018: 473; Schepker et al., 2014: 212–213).

The functional approach has been applied in many business studies before and after Schepker et al.'s (2014) conceptualization (see, e.g., Chen et al., 2018; Hofman et al., 2017; Lumineau, 2017; Lumineau and Malhotra, 2011; Malhotra and Lumineau, 2011; Mayer and Argyres, 2004; Mellewigt et al., 2012; Schilke and Lumineau, 2018; Wang et al., 2017; Wang et al., 2018). For example, Mayer and Argyres (2004) studied whether and how firms learn to contract in long-term customer–supplier relationships. They found, inter alia, that because of organizational learning, firms used contracts for communication (coordination), codification, and governance (safeguarding). Malhotra and Lumineau (2011), in turn, studied the effects of different contract functions on trust. They suggest that the safeguarding function may signal a lack of goodwill trust, whereas the coordination function may mitigate misunderstandings and strengthen goodwill trust. They also argue that both functions enhance competence trust, but in different ways.³ Examples of more recent studies that directly apply Schepker et al.'s (2014) classification of the functions of contracts include Wang et al.'s (2017) research concentrating

on the distinct effects of the three functions on cooperative behavior and the relationship between prior interactions and the contract's functions, as well as Chen et al.'s study (2018) that anatomizes FIDIC model contracts⁴ through quantitative content analysis.

However, the functional approach has, until recently, gained only little attention in legal research. Traditional legal scholarship has, for the most part, been interested in dogmatic studies of neoclassical contract law, alongside what we referred to above as the structural approach to contracting. However, some legal scholars approached contracts and contract law functionally well before Schepker et al.'s (2014) conceptualization. Indeed, Macaulay⁵ and Macneil were the first legal scholars⁶ who focused on the social or "relational" dimensions of contracts and founded the relational contract⁷ theory (see, e.g., Macaulay, 1963; Macneil, 1974). In the relational contract theory, the contract refers to more than simply a written agreement or a linguistic communication of the deal; the entire relationship as it has developed over the course of the relationship is what counts in the contract (Macneil, 1978). Relational contract theory can be seen as a legal counterpart to the complementary view and the functional approach to contracting; it calls for a contract law system that takes into account the interplay between relational governance and contracts and recognizes that contracts do more than simply lock the future.⁸

After the introduction of relational contract theory, many legal scholars followed in Macaulay's and Macneil's footsteps by viewing contracts, for example, as devices for coordination and control (Salbu, 1997); as social artifacts (Suchman, 2003); as organizations (Smith and King, 2009); as ex ante tools for shaping and planning business relationships, balancing risk with reward and preventing unnecessary problems, disputes and litigation (Haapio, 2013); as a source of competitive advantage (DiMatteo, 2010; Siedel and Haapio, 2010); as scaffolding (Hadfield and Bozovic, 2016); and as multifunctional and multivalent entities (Viljanen et al., 2018a, 2018b). The rest of Section 2.2 covers this field of legal research as much as it is relevant to our research questions.

To begin with, Hadfield and Bozovic (2016) found through their interview study of high-level executives in non-innovation- and innovation-oriented companies that a formal contract institution was used as scaffolding to support the effectiveness of informal enforcement mechanisms, such as early termination and reputational harm. When used this way, contracts are not meant as formal, third-party enforcement mechanisms and are thus used even in settings wherein the formal enforcement of contracts is weak or non-existent. Hadfield and Bozovic's (2016) findings support the complementary view and provide an alternative to traditional accounts of the relationship between formal and informal contracts that emphasize the safeguarding function of a contract.

Moreover, proponents of proactive contracting, an approach that is based on relational contract theory and preventive law⁹ and that was founded in the Nordic countries in the late 1990s and early 2000s (see, e.g., Pohjonen, 2002), focus on the functional sides of contracts. Numerous researchers have adopted the approach when studying, for example, long-term contracts (Nystén-Haarala, 1998), Next Generation Contracts (Haapio, 2013), contract simplification (Waller et al., 2016), and managers' and lawyers' views on the role of lawyers and contracts in

project business (Nuottila et al., 2016).¹⁰ Haapio (2013), for example, divides the functions of contracts into managerial functions and legal functions. Yet, as Haapio (2013) focuses on developing a vision for Next Generation Contracts and criteria for “good” contracts, she refrains from providing a systematic review or theory of the functions of contracts.¹¹

Lastly, a group of legal scholars has focused precisely on the contractual functions as classified by Schepker et al. (2014) by studying the juridical implications of the different functions and the changes in the juridical understanding of contracts, contractual practice, and the role of contracts (Viljanen et al., 2018a, 2018b). Viljanen et al. (2018a, 2018b) argue that the adoption of the functional approach to contracting in the legal field requires legal scholars and practitioners, first, to acknowledge the multi-functionality and multi-valence of contracts. Second, the scale of contracts should change from monolithic hundred-pagers to smaller entities. Third, the legal field should focus on the effectivity mechanisms of contracts that can be formal, traditional enforcement mechanisms, or something else. For example, the solemnity of imprinting signatures on paper, the presence of lawyers, and the “juridification” of the relationship all potentially affect the parties and influence their actions. Lastly, according to Viljanen et al. (2018a, 2018b), the changes in the juridical understanding of contracts transform the role lawyers play in designing and implementing contracts.

Overall, although the focus of both management and legal research has shifted toward the functional approach to contracting, most studies are somewhat siloed. Hadfield and Bozovic (2016: 6), for example, refer to the “scaffolding function of formal contracts” but link their study to the theories of incomplete contracting (see, e.g., Hart and Moore, 1998) and relational contracting (see, e.g., Levin, 2003), leaving out the discussion on the functions of contracts. Similarly, proactive contract scholars have refrained until now from reflecting their findings in connection to Schepker et al.’s (2014) classification. We aim to fill this gap by taking relational contract theory, the proactive contracting approach, and the functional contracting approach as our theoretical frameworks when studying how the different functions of contracts affect relational governance and IOR performance, and we hope to bring new and important elements into the discussion through our empirical research, which will be presented next.

3. Research design, methods, data, and analysis

To study how the different functions of contracts interact with relational governance and how they affect IOR performance, we designed a theory-generating expert interview study with 24 contract experts working in companies in the metals and engineering industries. We defined a contract expert as a person who works with contracts (inter alia contract drafting, contract negotiations, contract execution) on a regular basis. Thus, the interviewees represented a wide range of professions: there were altogether nine lawyers, two contract managers (one of whom was also a lawyer), five procurement professionals, four sales professionals, two CEOs, and three other types of professionals dealing with contracts daily.

We selected the interviewees based on a survey study that we conducted in autumn 2016 with 65 contract experts working in companies that at some point had participated in FIMECC’s research programs.^{12,13} All the survey participants were invited to participate in the interview study. Twenty-four of the questionnaire respondents volunteered. The semi-structured

interviews were conducted during autumn 2016. All of the interviews were individual interviews, except for one that was a group interview with two interviewees. The interviews covered altogether 17 companies. All the interviews lasted approximately one hour, they were conducted in Finnish, and they were tape-recorded. After the interviews, the recordings were transcribed verbatim and the transcriptions were coded in Nvivo 11.

The rationale of choosing theory-generating expert interviews as a method for our study stems from the knowledge in which we were interested, namely, the ways companies use contracts to govern business relationships and their effects on relational governance and IOR performance. To begin, contract experts have interpretative knowledge about contracts and contractual practice. Interpretative knowledge refers to the expert's subjective orientations, rules, viewpoints, and interpretations that structure the conditions of action of other actors in the expert's field. In other words, expert knowledge influences practice because an expert has the power to get his or her orientations enforced (Bogner and Menz, 2009: 54–55). Experts are also permitted to speak as a representative of an organization and be recognized decisively as such because of their ability to influence practice both inside and outside an organization (Littig, 2011: 1343). Consequently, the views of contract experts who draft, negotiate, and execute contracts on behalf of their companies affect the ways in which the companies use contracts. Thus, the knowledge they have was of interest to us as researchers.

As our aim was to develop further the theory of the functions of contracts via the interpretative generalization of typologies created based on the knowledge of contract experts (Bogner and Menz, 2009: 48), we followed the phases of thematic analysis presented in Braun and Clarke (2006: 86–93) in our coding and analysis processes. First, we familiarized ourselves with the data by reading the transcriptions, by listening to the recordings, and by correcting transcriptions when necessary. Thereafter, we designed the first coding scheme based on the interview themes¹⁴ that were theory-driven. We also wrote a summary of all the interviews to familiarize ourselves once more with the data and to ensure the coding scheme reflected the actual contents of the interviews. After this, we began to search and outline the themes for analysis by carefully examining the data extracts from the codes that were relevant to our research questions and by writing initial themes and sub-themes, as well as their descriptions, in a separate document. After the selection of initial themes and sub-themes, the transcriptions were coded again. The second coding was selective, as only the parts that were relevant in relation to the themes and sub-themes were coded. Finally, we revised the themes and organized them hierarchically.

Next, we move to present the results with extracts from the interviews, which have been adjusted for Standard English style. The results indicate, first, that firms use contracts to serve many functions. Second, they show how these functions can have both positive and negative effects on relational governance and IOR performance.

4. Results

4.1 The manifold functions of contracts

We decided to use the classification of Schepker et al. (2014) as our theoretical support in the analysis process, mainly for two reasons. First, it is the most comprehensive and refined theory on the functions of contracts. Second, by challenging the structural approach and its concomitant safeguarding function and by recognizing the adaptation and coordination functions of contracts, the approach captures the essential elements of past and current views on contracts.

Accordingly, as we analyzed the data, we expected to find that contracts were used to safeguard parties' interests, to adapt the relationship to possible changes, and to coordinate the information flows and roles and responsibilities of the parties. However, in addition to those three traditional functions, we found that contracts were also used in three other ways: to *codify* the deal, to *manage* the internal division of work and responsibilities, and to steer strategically present and future *collaboration*.

Before going into detail to describe the functions of contracts and their implications for IOR performance, it is important to note that the functions can operate simultaneously and different contract clauses or bundles of clauses can reflect many functions. For example, clauses on intellectual property rights naturally safeguard the parties' intellectual property, but they can also be used collaboratively when granting a free license to suppliers who could not by themselves afford it. Moreover, the relevance of different functions depends on the contract type and context. For instance, while the coordination function is stressed in certain businesses, such as transportation, construction, and ICT, the collaboration function might be emphasized in long-term, trustful relationships. Now, we move to present the findings concerning the safeguarding function.

4.2 The safeguarding function and its effects on relational governance and IOR performance

To begin, according to the interviewees, contracts were indeed used to safeguard all the parties' interests. On one hand, safeguarding was regarded as an essential function of a contract and, when used correctly, it could support IOR performance. Clauses used for safeguarding included, e.g., liabilities, warranties, clauses on intellectual property rights and non-disclosure, clauses on supplier requirements and supervision, and clauses on conflict management and dispute resolution. One interviewee described how the protection of sensitive information enabled a more open relationship:

“So, NDAs are of course there with these main partners so that the information exchange is in a way more fluent when both parties can be more open...” (Designer, Company 17, H23)

On the other hand, clauses that safeguarded parties' interests but were one sided were regarded as hindering IOR performance. These kinds of terms were used especially in supplier relationships and, while almost all the interviewees regarded the model as collaboration-adverse when they were in the position of a supplier, they applied the same model when they

were in the position of a customer. The approach is known as the antagonistic or arm's-length model, and it can have serious disadvantages for both the supplier and the customer (Cova and Salle, 2000; Matthyssens and Van de Bulte, 1994; Moeller et al., 2006: 70). In the interviews, many examples of the arm's-length model with its negative consequences emerged. Interviewees described how customers wanted to "try their luck" or "slipped unfair terms into the contract." One interviewee described aptly a contract that is full of one-sided terms as useless:

"...it's a completely useless paper, that kind of 40-page contract, half of which is sanctioned and, first, they are completely unreasonable, the terms, so if one goes to trial, the court would first make the terms equitable, and they [the terms] don't have any practical relevance. It's a pure waste of time." (CEO, Company 13, H19)

The antagonistic approach often started already at the contract negotiation phase as contract drafters were concentrating on safeguarding their own interests at the expense of others. In particular, lawyers as contract drafters were sometimes seen to hinder the development of relational norms and collaboration by hindering negotiations, complicating contracts, and concentrating on irrelevant details without understanding the big picture. Moreover, contracts drafted by lawyers were regarded as long and as packed with unnecessary legalese and complicated English. At worst, neither of the parties understood to what was agreed, and the drafting process was regarded as a waste of time:

"...sometimes when I am [...] entering into agreements, neither the buyer nor I know exactly what we are signing in there. It might be that when a dispute arises, it is a good paper then but we do not know that. Perhaps the idea should be though that we would know that." (CEO, Company 13, H 19)

Lastly, especially lawyers regarded their role as essential for contract drafting and sense making. This was especially the case with legal contract terms, such as intellectual property rights:

"...then if a non-lawyer tries to agree on some legal matter, let's say something like ownership of IPR or an R&D agreement, then you are going to get things completely wrong because a non-lawyer cannot write it in a way that would lead to some sound result, so that it would have the outcome that was intended." (Lawyer, Company 7, H8)

4.3 Adaptive clauses, relational governance, and IOR performance

Concerning the adaptation function, while the interviewees described how their companies used, e.g., price adjustment clauses, clauses on buffer stock, clauses on change management, and clauses on contract termination, the formal contract terms were often complemented by relational governance, as contracts were silent or things did not go as planned (see also Poppo and Zenger, 2003: 713; Schepker et al., 2014: 201–202). For example, when the prices of raw materials increased and the contracts did not have any price fluctuation clauses, the parties were nevertheless prepared to change pricing terms. In addition, in the case of a delay in delivery, the companies did not automatically demand penalties. Moreover, the companies were ready to concede minor scope changes. Lastly, when changes occurred or things went wrong, contracts were put aside and the parties tried to settle issues amicably, without litigation. In the below quote, an interviewee describes how litigation is avoided to preserve good

relationships, a point noted already by Macaulay (1963: 61, 64) and confirmed by a more recent study by IACCM (2013):

“Of course the projects are managed as well as possible and of course we walk on eggshells with a good customer because although agreements are agreements, one tries to avoid disputes to the last. So that one doesn’t end up on a black list...” (Project Manager, Company 9, H13)

4.4 The coordination function of a contract

Clauses reflecting the coordination function were used especially in project business, in consortia, in R&D agreements, and in businesses with a high degree of uncertainty. This is in line with Chen et al. (2018: 482), who found that the coordination function is actually as important as the safeguarding function in construction project contracts. Clauses on project organization, steering group protocols, meeting protocols, schedule management, cost management, and change management were important for project deliveries. Very often, however, projects were started before agreeing on these issues, and this could result in difficult situations during project execution:

“...and they are good to be agreed upon in advance because if they are not agreed upon, they can often lead to difficult conversations on who actually pays. And this usually forces both parties to try to keep to the schedule so that things don’t end up like in Olkiluoto.¹⁵ And then one can fight about that for quite a long time. I would consider this an opportunity; we are not perfect in this in my opinion. This is something where we really have much to improve still. And so have many others, as well because quite seldom these are... project is kicked off but preconditions are not actually agreed on, so I would consider this as an opportunity...” (Procurement manager, Company 11, H 12)

Finally, contracts’ coordinative clauses were sometimes complemented by relational governance that was used to agree on practical issues, such as daily communication. The formal contract, however, existed at least in the background.

4.5 The unexplored functions of contracts

In addition to the three “traditional” functions, companies also used their contracts to codify their deals, to manage the internal division of work and responsibilities, and to steer strategically present and future collaboration.

To clarify, *the codification function* refers to contractual techniques that put together and verbalize the deal for all parties. Clauses that reflect the codification function include, inter alia, scope, roles and responsibilities, price, and delivery time.

Clauses reflecting the codification function, and especially clauses relating to the scope, were the most discussed terms in the interviews. The scope, as well as the scope interfaces needed to be clearly defined, and both parties had to have a mutual understanding of the scope. This also meant that contracts should be detailed, coherent, and not open to interpretation. According to one interviewee, frequently, the purpose and the outcome of the contract, as well as its scope were not clearly defined, even though it should be self-evident:

“Well... it is, obviously this is self-evident, but in a way, the documentation of the purpose of a contract. So, kind of, the responsibilities and the obligations are clearly defined, which as such should be self-evident but actually is not always. So it is crystal clear why the agreement is made

and what one tries to achieve with it, and the obligations and the performing parties should be clearly defined.” (Procurement manager, Company 8, H18)

Sometimes, contracts did not codify the deal reasonably but were unfit for purpose and thus hindering IOR performance. The reasons for the unfitness were manifold. First, contracts could have been unfit from the beginning because they were drafted by using old contracts or contract templates from different industries. Second, contracts were often unfit for purpose from the beginning because the people who were drafting the contracts were not executing them and were thus unaware of the practically best option to execute the project. Third, contracts could become unfit over time; clauses that had been originally designed to support and even boost IOR performance could lead to the opposite because they no longer reflect the relationship and practice. One interviewee described how contracts that were based on templates designed for a different industry were full of terms that nobody understood:

“...even the customers, their own crew, admitted that sometimes they have difficulties in reading the contracts and interpreting them and finding information from them, because they are drafted from a very generic template.” (Designer, Company 17, H23)

Based on the interviews, it seemed that contracts were used in a further manner to steer the internal work and processes of a company (*the internal management function*). An example of a clause that serves not only the coordination function but also the internal management function of a contract is a single-point-of-contact clause.

When contracts were used for internal management, they aimed at communicating the objectives and scope of the deal internally, not only to people who had negotiated or drafted the contract but also to others. This is important because ambiguities in clauses serving the internal management function can result in the misallocation of resources and can negatively affect IOR performance, as described by one interviewee:

“...so it [unclear objectives] can result in...misunderstandings and possibly to...misallocation of resources, and of course it can also affect external relationships so that...it’s not an ideal situation for the company, neither internally nor externally.” (Procurement manager, Company 8, H18)

Lastly, the companies used contracts to plan, promote, and steer collaboration over the ongoing contractual relationship. By collaboration, we refer to Schöttle et al.’s (2014: 1275) definition, according to which in a collaborative IOR, at least two autonomous organizations create a relationship with a common vision, a common project organization with a commonly defined structure, and a new and jointly developed project culture based on trust and transparency. In a collaborative IOR, the goal is to maximize jointly the value for the customer by solving problems mutually through interactive processes that are planned together and by sharing responsibilities, risk, and rewards among the key participants. Compared to cooperation, where all participating organizations have their own visions and project organizations and the project culture is based on control and coordination to solve problems independently to maximize the value of the organization, collaboration is “deeper” and strongly correlated to trust, communication, commitment, knowledge sharing, and information exchange (Schöttle et al., 2014: 1275). Contract clauses that support the creation of a collaborative IOR serve *the collaboration function of a contract*, and examples of these kind of clauses include clauses on joint project organization, joint schedule management, and joint cost management.

Compared to the coordinative clauses that steer workflows and information flows and dispute management procedures during the deal at hand, collaborative clauses are future-oriented and aim to create added value for both parties. For example, if coordinative clauses set the scene and procedures for conflict management or dispute resolution, clauses serving the collaboration function try to avoid such disputes in the first place. If, however, a dispute arises, collaborative contract clauses provide a future-oriented solution to settle the dispute amicably so the business can continue. Examples of collaborative dispute resolution systems include so-called dispute boards that are used in many construction projects.

The need for collaborative clauses was emphasized in complex and long-term deliveries, such as in R&D, construction, and IT projects. This is noted also by Frydinger et al. (2016: 41), who argue that collaborative contracts that focus on building the relationship should be used especially for more strategic deals. The clauses used by the participating companies included, *inter alia*, clauses on pain and gain sharing, open book clauses, clauses on licensing, options to extend or renew the contract, clauses that strategically coordinated the present and future relationship, and conflict management clauses that sought to resolve disputes amicably. Binding order forecasts, volume commitments, volume discounts, and supplier programs are examples of collaborative clauses used in supplier contracts.

As noted by Schöttle et al. (2014: 1275), collaboration requires a process of development. Similarly, according to our interview data, relational governance developed over the course of the relationship influenced the use of collaborative clauses. In some circumstances, according to the interviewees, when the parties knew and trusted each other, they were more likely to use contracts that are more complex, with various collaborative mechanisms, such as gain and pain sharing clauses and open book clauses. Moreover, if used wisely, the terms enabled a highly motivated business environment:

“...if you can control and understand what you are doing, you can create a business environment that motivates both parties to act...” (Lawyer, Company 5, H6)

In other circumstances, in turn, when the parties knew each other, the role of the contract was less important than when the parties were new to each other:

“...but then when there is a totally new operator, for example, who joins the gang and who has been selected for the first time, then the agreement has a more central role than in situations where you have done business together for 15 years and you know each other quite well and are familiar with the resources and risks, and probably the communication and earlier experiences also support the management of the business relationship...” (CEO, Company 13, H19)

To recap, our results indicate that companies use contracts to not only safeguard, adapt, and coordinate IORs, but also codify the deal, manage their internal workflows and personnel, and steer and manage collaboration in the IOR over the ongoing contractual relationship. We now move to elaborate the findings in relation to both theory and practice and present our concluding remarks. Finally, we consider the limitations of our research and suggest ideas for future research.

5. Discussion and conclusions

5.1 Theoretical implications

In this article, we have investigated the functions by which companies use contracts and their effects on relational governance and IOR performance.

We found that, in addition to the traditional functions, that is, safeguarding, adaptation, and coordination, contracts were also used to serve three other functions, namely, codification, internal management, and collaboration.

First, whereas the safeguarding clauses were viewed as supporting relational governance and IOR performance when used intelligently, excessive and one-sided safeguarding clauses were seen to hinder IOR performance and the development of relational norms. This arm's-length model was used in particular with suppliers and the approach was adopted early during contract negotiations. Schilke and Lumineau (2018) reached the same conclusion by showing that even clauses serving the same function (e.g., control or coordination) can have both negative and positive effects on performance, depending on, for example, environmental dynamism.

Especially lawyers were seen to focus too much on safeguarding clauses and therefore they were seen to hinder negotiations, complicate contracts, and concentrate on irrelevant details without understanding the big picture. Lawyers themselves, however, regarded their role as essential for contract drafting and sense making. These results have important implications also noted by previous research. To begin, lawyers are not always the best contract drafters. This is especially the case with regard to clauses on roles and responsibilities, communication, and contingency planning, as these kinds of clauses require firm-specific and tacit knowledge. In these situations, managers and engineers are the primary repositories of a company's contract design capabilities. However, lawyers possess stronger contract design capabilities relating to, *inter alia*, clauses on dispute resolution and intellectual property rights (Argyres and Mayer, 2007). Furthermore, strong involvement of lawyers in contract drafting may lead to too much focus on safeguarding clauses (Schilke and Lumineau, 2018). On the one hand, this can affect the willingness of engineers and managers to involve legal departments in contract drafting and negotiations (Macaulay, 1963; Timmer, 2016; Nuottila, 2016). On the other hand, the frustration of engineers and managers in working with lawyers can create a bond between employees from two companies, which can enhance interorganizational collaboration, paradoxically (Argyres and Mayer, 2007).

Second, while the companies represented by the interviewees used adaptive terms to prepare for possible endogenous or exogenous changes in the relationship, relational governance, such as flexibility and solidarity, complemented the use of adaptive clauses, especially when contracts were silent or things did not go as planned. To support IOR performance and to avoid unnecessary escalation and black listing, contracts were sometimes even put aside. Indeed, previous studies, both academic and practical, have shown that litigation is rare and disputes are often settled without any reference to formal contracts (IACCM, 2013; Macaulay, 1963: 61). As Ferguson et al. (2005: 221) have noted, it seems that businesspeople sometimes ignore the technically correct legal implications of contracts. Lastly, relational governance seems to foster "continuance and bilateralism when change and conflict arise" (Poppo and Zenger, 2002:

713) and when contracts do not offer any help to solve the problem (see also Schepker et al., 2014: 201–202).

Third, as also shown by Chen et al. (2018), the coordination function seemed particularly important in project business, in consortia, in R&D agreements, and in businesses with a high degree of uncertainty. Our results highlight the importance of agreeing on coordinative clauses in advance, because otherwise the execution of the project might be imperiled. This notion is well in line with, for example, Mayer and Argyres (2004: 404), who found that a lack of coordinative clauses resulted in coordination failures and other “honest mistakes.” The companies in their case study aimed at avoiding these failures by incorporating provisions on change management, project scheduling, and disclosure of information into later contracts.

Fourth, codification seemed the most important and most often referred to function in the interviews. The codification function of a contract can be described as an *ex ante* function, as its emphasis is on the pre-award and award phases of the contract lifecycle. It incorporates the idea of a contract as a script, as introduced by Suchman (2003), and the ideas of contracts as repositories/storehouses for knowledge and the contracting process as an organizational learning device (Lumineau et al., 2011; Mayer and Argyres, 2004). As Lumineau et al. (2011: 22) show in their case study analysis, the detailed drafting of contract clauses enables the companies to codify their goals and expectations and to grasp a better understanding of the deal. Moreover, contract as a codification device nudges the parties into carefully thinking through the choices they want to make in relation to, for example, their business partner and the juridical framework of the relationship. Finally, proper codification can enhance the development of trust, as misunderstandings relating to scope and scope interfaces are avoided (see also Mayer and Argyres, 2004: 401). This seems to be common sense, but it is normal not to “live up to this ideal” (Macaulay, 1963: 58), in which case contracts can hinder IOR performance.

Fifth, contracts were used to organize roles, responsibilities, and communication internally, within an organization. This function has indirect implications for IORs, as internal ambiguities can result in the misallocation of resources and reputational harms. Indeed, Mayer and Argyres (2004) describe how conflicting instructions from a variety of the customer’s personnel can result in delivery delays. In their case study, the problem was resolved by, *inter alia*, adding a single-point-of-contact clause in the contract (see also Argyres and Mayer, 2007). In addition, Macaulay (1963: 65) mentions the internal management function in passing when describing how contracts can be used for internal planning. To our knowledge, apart from these studies, the internal management function has been neglected by previous research.

Sixth, our results show how contracts were used to plan, promote, and steer both ongoing and future collaboration. As discussed in Section 4.5, collaborative contract clauses support the creation and development of IORs, where participating organizations share a common vision, a common project organization, and a common project culture. Thus, while the collaboration function resembles the coordination function, it aims to create a strategic relationship for the future. Actually, the difference between the coordination function and the collaboration function can be illustrated with the help of a comparison between time tellers and clock builders, originally presented by Collins and Porras (1994) and aptly used in Frydinger et al.

(2016: 22) to compare transactional contracting and relational contracting: in coordination, the focus is on telling time (on the deal). In collaboration, the focus is on building a clock (on building the relationship for the future).

As noted by previous research (Frydlinger et al., 2016: 41), the need for collaborative clauses was emphasized in complex and long-term deliveries. Moreover, relational governance that develops over the course of the relationship seemed to influence the use of collaborative clauses, as the parties were more likely to use contracts more complex, with collaborative clauses, when they knew and trusted each other. Indeed, on the one hand, our results support the findings of Poppo and Zenger (2002: 713), according to whom relational norms and “lessons learned” enable greater specificity and complexity in contractual provisions. On the other hand, our findings also suggest that the role of the contract is emphasized at the beginning of the relationship, and it becomes less important when the parties know and trust each other. Huang and Chiu (2018: 269) have come to the same conclusion, arguing that relational mechanisms cannot effectively facilitate collaborative performance at the beginning of the relationship because trust has yet to be developed. By contrast, the role of relational governance becomes emphasized as the relationship develops. Furthermore, Mayer and Argyres (2004) have found that a detailed contract that specifies the expectations and roles and responsibilities of the parties supports the development of trust.

In sum, our findings contribute to and develop the theory of the functions of contracts. By adding three functions to Schepker et al.’s (2014) classification, we hope to highlight that, first, contracts can be used in versatile ways; while contracts can be used fairly simply to put together the pieces of the deal, they can and should also be used to govern both interfirm and intrafirm social behavior (Frydlinger et al., 2016: 26). Second, contracts affect social behavior and performance (e.g., Cao and Lumineau, 2015: 30). More specifically, the different functions can have different effects on IOR performance and trust (see, e.g., Lumineau, 2017; Schilke and Lumineau, 2018). Thus, contract design matters.

5.2 Managerial implications

In addition to the theoretical contributions discussed above, our research has implications for managers and contract experts.

Principally, managers have to pay attention to both the contracts’ contents and design because these aspects can influence relational governance and IOR performance both negatively and positively. On the one hand, vague, one-sided, or unfit contracts can sow the seeds for a future dispute, and on the other hand, a clear contract that is aimed at safeguarding all the parties’ interests and results in a win-win situation is likely to support the development of relational norms and trust and boost IOR performance. In sum, contracts can be intentionally designed to hinder or boost IOR performance and to ignore or take into account the social dimensions of the relationship (see also Frydlinger et al., 2016: 22).

In addition, the role of lawyers in negotiations and contract drafting should be discussed within companies. Lawyers are indeed needed, especially when agreeing on legal matters, such as dispute resolution clauses or intellectual property rights. In addition to lawyers, it is the case

that commercial people, technical people, and the people executing the contracts should be involved in the drafting process to ensure the contract reflects reality and that it does not contain provisions that are conflicting, purposeless, or even hindering IOR performance. In fact, it may well be that the clauses that offer companies a competitive advantage may not be the terms that the legal departments are capable of drafting (Argyres and Mayer, 2007). Thus, an effective contract design process calls for cross-professional collaboration.

In conclusion, managers and contract experts need to remain aware that contracts can be used for different purposes. To begin, they can be used fairly simply to codify the deal and to safeguard the parties' interests. In addition, they can be used to adapt the relationship to changes that occur over the course of the relationship and to coordinate the parties' relationship to affect social behavior internally and externally. When used innovatively, for example, contracts can be framed to encourage trust (Cao and Lumineau, 2015: 30) and to steer and plan ongoing and future collaboration strategically. If, however, the social dimensions of contracts are neglected or the purpose and function of a specific contractual technique are not properly understood but implemented anyway, the relationship can be seriously damaged.

5.3 Limitations

Our research has several limitations. First, the interviewees do not constitute a representative sample of any group of contract experts, but they were selected based on an ongoing research project. Second, it seemed that the companies and the interviewees involved in our study were quite advanced concerning contractual practices. This might be because most of the companies involved in the study were large companies that operated in international markets. Thus, the results may have been quite different if the interviewees had been other than experts in the field of contracts or if they had been representatives of small and medium sized companies. Third, qualitative research has often been criticized because its quality is hard to assess. To aid the assessment of the quality of this research, we have openly described the research design, the method, the data, and our analysis process. Because of the limitations relating to our data, the findings are not intended to be generalized as the findings of quantitative research. Rather, they are intended to raise cross-professional discussion on contractual governance and its effects on relational governance and IOR performance, both on a theoretical and practical level.

5.4 Future research

Our study opens a wide range of themes for future, interdisciplinary research. In relation to the interplay between relational and contractual governance, it would be interesting to study how contract simplification processes have actually affected IOR performance. In addition, since relational governance and contracts are used together in practice, future research could focus on how contracts can support relational governance and IOR performance, especially in collaborative IORs. It would also be critical to study why contracts are still seen as a signal of lack of trust. Moreover, future research could compare different business fields concerning their contractual practices. Finally, it would be important to study whether the role of relational governance and contracts is different in small and medium sized companies.

In relation to the functions of contracts, more research is needed to test our classification. Because the functions may change when institutional environments change (Cao and

Lumineau, 2015: 31), it would be important to test the functions in relation to different contract types and IORs, such as service agreements, construction contracts, and consumer contracts, as well as alliance contracts, joint ventures, and so on. Moreover, future studies could focus on the legal implications of the functions. Most importantly, future studies should acknowledge the interdisciplinary nature of contracts; thus, the research groups should comprise a variety of academics, such as economists, management scholars, legal scholars, and designers, as well as practitioners, such as managers, lawyers, and engineers.

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¹ To be precise, Dyer and Singh (1998) divide the governance mechanisms into two groups and use the terms “agreements enforced by third-parties” and “self-enforcing agreements.” They further divide the self-enforcing agreements into two sub-groups: formal and informal self-enforcing safeguards. Because the terms used by Dyer and Singh are somewhat misleading in our view, we decided to use the terms “formal governance mechanisms” and “relational governance mechanisms” in this article.

² In our view, there are quite a few problems with Dyer and Singh’s (1998) reasoning and arguments, as they claim that “self-enforcing mechanisms are more effective than third-party enforcement mechanisms at both minimizing transaction costs and maximizing value-creation initiatives” (Dyer and Singh, 1998: 670). First, when comparing self-enforcing governance and contracts, they have not taken into account costs that incur when self-enforcing governance fails, such as in situations where the scope of performance is unclear. Moreover, in our view, they have misunderstood how contracts are monitored by claiming that contracts are always monitored by third parties (e.g., courts). This is rarely the case in practice, as contracts are first and foremost monitored by the parties themselves. Third parties are called upon only as a last resort.

³ In business studies, trust has been defined as “the psychological willingness of one party to be vulnerable to the actions of another in a risky situation” (Mayer et al., 1995). Trust is divided into competence trust, namely, the partner’s ability to perform according to agreements, and goodwill trust, that is, the partner’s intention to perform according to the agreement (Nooteboom, 1996).

⁴ FIDIC is a French language acronym for Fédération Internationale Des Ingénieurs-Conseils, which means the international federation of consulting engineers. It has become famous for producing standard form contracts that are used worldwide in the construction and engineering industry.

⁵ Macaulay (1963: 67) already wrote about “the functions of a contract” but left it only as a brief reference.

⁶ Macneil challenges this conception by showing that the relational contract has been part of American law for quite some time (Macneil, 1985).

⁷ A relational contract means different things in legal research and in economics. In economics, a relational contract refers to a game-theoretical organizational capability, “the shadow of the future:” when there is a sufficiently long window of future exchange such that the gains from repeat business outweigh the gains from self-interested behavior, the interfirm exchange may be more cooperative without enforceable contracts (Baker et al., 2002; Schepker et al., 2014: 202).

⁸ Macneil uses the term “presentation” to refer to a situation where the future is “locked” (Macneil, 1978: 863).

⁹ The father of preventive law is Louis M. Brown. For more on preventive law, see, e.g., Brown (1950) and Haapio, (2013: 38).

¹⁰ For more studies, see Haapio (2013: 37–43) with references. For the history of the movement, see Berger-Walliser and Østergaard (Eds.) (2012).

¹¹ It does, however, provide a list of the managerial functions of contracts. According to Haapio (2013), contracts are instruments for 1) coordinating and managing business, projects, and commitments; 2) creating, allocating, and protecting value and realizing benefits; 3) communication, motivation, and control; 4) sharing, minimizing, and managing risk; and 5) preventing problems and controlling and resolving disputes (Haapio, 2013: 29).

¹² The study was a part of the FIMECC REBUS program. FIMECC was a strategic center for research in the Finnish metals and engineering industries. In 2016, FIMECC merged with DIGILE, and the company changed its name to DIMECC. Until 2016, there were altogether 137 companies that had participated in FIMECC’s research programs.

¹³ The results of the survey study are discussed (in English) on pages 143–147 of the final report of the REBUS program, available at: <http://hightech.dimecc.com/results/final-report-rebus-towards-relational-business-practices> (accessed 11 September 2019). A full report of the survey study (in Finnish) is available at: <https://www.utu.fi/fi/yliopisto/oikeustieteellinen-tiedekunta/tutkimus/katsauskia-ja-tutkimusraportteja> (accessed 11 September 2019).

¹⁴ The interview themes were: background information, dependency, contracts and collaboration, contracts and relational governance mechanisms that hinder collaboration, contract negotiations and the functions of contracts, and relational means to govern collaboration.

¹⁵ Olkiluoto 3 is a notorious nuclear power plant project that commenced in Western Finland in 2005. The start of the commercial operations was originally planned for May 2009 but the project has been delayed and is still

ongoing. All of the customer, TVO, and the contractor, Areva, took legal actions against each other until they were settled by an agreement reached in March 2018.

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