Flexibility in contract terms and contracting processes

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Abstract

Purpose – New business models, such as life-cycle contracting, challenge the narrow and static understanding of contracts with hard and precise terms. The aim of this paper is to examine how flexibility could be incorporated into contracting processes.

Design/methodology/approach – The data of the paper have been gathered applying the triangular method; first, by interviewing key personnel participating in contracting at eight Finnish firms; second, examining contract and other documents of those companies; and third, studying earlier research on contracting practices. Theoretically, the paper is based on relational contract and proactive approaches to law on the one hand and on organizational studies based on new institutional economics on the other.

Findings – Flexibility is often introduced to contracts with relational methods, relying on good personal relationships between business partners or negotiation power and negotiation skills. Contract documents often do not contain mechanisms for dealing with contingencies, or “soft” contract terms. The paper finds the following reasons that may explain this. First, firms heavily rely on model contracts to develop their own templates and the lack of contract models in new business areas hinders firms to develop their templates. Second, unfamiliarity with using soft elements makes it difficult to use them. Additionally, in some cases firms may prefer using relational capability.

Research limitations/implications – The findings need verification from further multidisciplinary empirical research.

Practical implications – The findings support firms in developing their contracting capabilities to meet the requirements of the changing business environment and gain competitive advantage from well-organized contracting.

Originality/value – This paper is one of the first empirical studies comprising also the legal approach.

Keywords Contracts, Business planning, Contract law, Finland

1. Introduction

Business people often understand contracts as legal documents, designed by lawyers in order to protect firms against risks and prepare them for potential litigation in the worst case. The paper was originally delivered at the International Project Management Association 23rd World Congress Conference held in Helsinki, June 15-17, 2009. Papers were double blind reviewed and subsequently amended and expanded to reflect the project management perspective and further reviewed.
case scenario. At the extreme, contracts may be viewed as a necessary evil. If a sales unit of a firm holds this view of contracts, they may be viewed as a burden, and perhaps even a hindrance, to the smooth conclusion of business. While contracts do have functions other than safeguarding, this function often seems to be viewed as its only one. Contributing to this view is the classical model of contracting parties in contract law. Often contracting parties are seen as confrontational with opposing interests. Since this hard contracting model or hard approach to contracting emphasizes the opposing interests, it highlights the need of the parties to safeguard themselves against risks, with precise and unchanging hard terms.

However, increasingly, changes in the market and the need for long-term cooperation in business challenge this hard approach to contracts. Long-term cooperation requires flexibility and emphasizes common interests and shared risks, instead of simply trying to assign the risks to the other party. In long-term cooperation, the coordination and organization of the business processes becomes more important and the project may require systematic and continuous process documentation. In these projects, the interests of the parties are often aligned and do not contradict each other. Partnering and alliances are good examples of a strong need to find common interests for both parties and where the processes of all the parties become closely intertwined (Walker and Hampson, 2003).

Furthermore, changing market conditions may require soft terms in contracts, “soft terms” in the presence of foreseeable uncertainty. Joint innovation is an example of a case where hard and soft terms may become contrasted. Parties in joint innovation project cannot only often foresee the common goals, but also predictably, the actual outcome is uncertain and the boundary of the rights arising from the results tends to be unclear (Lee, 2008). This is due to the fact that parties do not know what results the collaboration will produce, or sometimes if any will be produced at all. In such cases, parties may anticipate the uncertainty of the actual costs and benefits of such collaboration. If contracts are written using hard and unchanging terms, the contract cannot be complete because of a lack of specification; uncertainty over the outcome also makes the contract incomplete. On the other hand, parties may utilize soft terms requiring flexibility, good will, and commitment from the parties. In such contracts, contract terms tend to provide a framework for cooperation rather than hard and precise risk and cost allocations. Thus, contracts are either incomplete with precise hard terms or incorporate soft terms with vague standards that would later allow the parties the opportunity for further specification. When such “soft” terms become decisive, the terms may not even vaguely resemble a contract from the perspective of the hard contract model (Gilson et al., 2009).

Hard elements of a contract are a result of economic inevitability, profit maximization and cost saving. Soft elements are connected to flexibility, taking partners into consideration for their mutual benefit. Through soft elements of contracts, uncertainties may be managed. Soft elements add flexibility and adjustability to contracts and the contracting process. Soft contracting complements the contracting capabilities of firms. As an organizational capability to align contracting practices with business models, contracting capabilities may transform contracts and the contracting process from mere papers safeguarding against potential legal risks to tools of cooperation.

Building on the previous research project work on Corporate Contracting Capabilities (CCC Project Final Report, 2008), this paper examines how soft contracting incorporates
flexibility into contacts and complements the existing contracting capabilities of firms. Additionally, we also explore why soft elements in contracts are underutilized. In conclusion, we propose that contracts and contracting be understood as a way of balancing the trade-offs between hard and soft elements and that the optimal management of contracting capabilities needs to take these trade-offs into consideration.

2. Literature review

Though the literature concerning contracting is diverse there is still no single comprehensive theory of contracting. Contract theories tend to study different aspects of contracting. Largely, there are two schools of research criticizing the rigidity persistent in contract and contract law research. One approaches contracting from the contract law perspective and criticizes the rigid nature of contract law. The other approach has its roots in the criticism of the rigidity of neo-classical economics. Although they sometimes share elements and influence each other, they have existed quite separately. Research that combines these two approaches is rare, despite the clear need to study the functions and use of contracts from a multidisciplinary approach. In this section, we present both streams of research and discuss the need for a comprehensive theory of contracting.

2.1 Contracting practice in contract law studies

The rigid nature of contract law has been recognized in legal studies and there have been different scholarly attempts to include contracting practice into these studies. The need for empirical studies of contracting was clearly presented in Macaulay’s famous article from 1963. He showed that business people’s perception of contracts is entirely different from what is in contract law defined. According to Macaulay, business people only made deals and offers, but avoided “contracts”. Thus, contracting in practice differs largely from what contract law models the practice to be. Soft elements of contracting were often not recognized as contracts (Macaulay, 1963).

In Western countries, the tendency seems to be away from gentlemen’s agreements, which Macaulay (1963) described and towards an increasing use of formal contracts because of the globalizing environment — for instance, in Scandinavian countries were cooperation without formal contracts or with lean framework type of contracts has been typical in the small markets where contracting partners know each other, business people now report that formal contracts have become more important because of the rapidly and unexpectedly changing environment. “We cannot rely on gentlemen’s agreements anymore, because a competitor can buy our cooperation partner […] It was a shock in Finnish industry, when company X bought everybody else’s suppliers” (Interview with an Engineer). On the other hand, globalization has forced companies to meet with other cultures in which informal relational methods are often applied in business instead of formal contracts or they overrule formal contracts. For example, the Chinese Guang Xi – attitude (Wang and Liu, 2007) requires more relational capabilities from Western business people, who are more used to operating with formal contracts.

In the USA, where contracts traditionally tend to be long and complex, Macneil (1978) and Macneil and Gudel (2001) continued Macaulay’s approach and developed a “relational contract” theory. Macneil’s view is that a contract in contract law in its classical form represents a discrete contract made only once between the parties. Thus, the strictly binding nature of a contract then protects the parties and helps the business develop. In contrast, this strictly binding nature causes problems in long-term relations,
due to the need for flexibility. Neo-classical contract law tries to solve the problem with general clauses and principles such as good faith and fair dealing. According to Macneil, these neo-classical tools function as additional exemptions in the classical system of contract law. Long-term cooperation, however, requires relational contracting, which approaches contracting as a developing process and a relationship in which future and reputation matters and risks and benefits are shared (Macneil, 1978).

Macneil’s relational elements are close to what we in this paper term soft elements. Relational contract theory represents scholarly attention to soft elements in contracts and how contract law should treat them. Relational contract suitably describes long-term cooperation in new business models and it is useful in understanding research and development (R&D) innovation contracts. As a contract with inherent uncertainty, a contract for R&D or joint innovation cannot define the final result or even how to reach it. Open and flexible soft elements dominate such contracts. Furthermore, increasing partnering and alliancing also increases the significance of flexible relational contracting (Walker and Hampson, 2003). Traditional supplier contracts with strict supplier’s liabilities strengthened with liquidated damages need to be amended with mechanisms of change allowing flexibility.

Macneil suggests that every contract contains relational elements, which should also be recognized in contract disputes in courts. Similar ideas on opening the legal framework for co-operational settings are also found in Finnish contract law literature, such as Rudanko’s (1995) open model and in Karhu’s (formerly Pöyhönen (2000)) new property law theory. More recently, Annola (2003) has highlighted the difference between static and dynamic contracts, arguing that long-term contracts, which are meant to be modified and supplemented during the life-cycle of the contract, are dynamic. In the context of dynamic contracts, it is possible to emphasize the application of content-related contract law principles (e.g. the principle of good faith and fair dealing and the principle of loyalty) which especially in Nordic and German (Treu und Glauben) legal studies are strongly related to flexibility, in order to respond to the characteristics of dynamic contracts.

Similarly important to our hard and soft contracting concept is the theory of incomplete contracting, in more traditional contract law research literature. Several authors started to observe that in practice almost all contracts are either open-ended or incomplete, and lie within context of contract interpretation in courts (Kreitner, 2006, pp. 163-75; Hadfield, 1990; Barnett, 1992; Zamir, 1997; Goldberg, 2002). This observation mainly leads to the question of how significant the absent or non-existent part of the contract is for dispute management. The observation that almost all contracts are incomplete recasts the role of contract law and court-based dispute resolution and challenges the static and hard contracting approach.

Another attempt to incorporate contracting practice into contract law can be found in a more practice-oriented approach which sees contracts as tools for business, not as objects of disputes in courts (Haapio, 2006, 2007; Pohjonen, 2002; Wahlgren, 2006; Barton, 2009). This proactive approach applies the knowledge gained from preventive law, which Louis M. Brown started in the USA in the 1950s. Brown (1950) saw that disputes often occur because they have not been prevented beforehand and observed that often unnecessary disputes could have been avoided with better planning. Proactive law broadens this perspective and claims that pro-activeness may not only prevent disputes but can be applied beneficially in various types of business contracting (Haapio, 2006). Since the difference between preventive and proactive approaches is,
however, only a small one in the focus, the proactive approach being more business oriented, they can be treated as one approach. Both preventive and proactive approaches recognize that disputes are not always avoidable. The preventive/proactive approach suggests that even these unavoidable disputes may be proactively managed within the business context, without necessarily turning them into full-blown courtroom disputes. As the preventive/proactive approach emphasizes how important is contracting in practice, it highlights the need for empirical studies of contracting. As a critique, proactive scholars claim that contract law is only a small part of contracting practice, and thus, organizational and business discipline may need to have to be included in studies on contracting.

2.2 New institutional economics and multidisciplinary empirical studies
Contracting is a process of the market-based exchange of privately held legal rights and goods. Contracts and contracting are private economic activities and thus a subject of economists and business scholars. As it lies at the intersection of legal rights and economics, it often captures the interests of the economists and legal scholars who study the interaction of law, economics and institutions. Famous works by Coase (1988, p. 6) highlighted the presence of transaction costs, i.e. the costs of monitoring and enforcing contracts, in addition to production costs. He argued that efficient market exchange can be hindered by the presence of transaction costs (Coase, 1960, p. 119) and the role of institutions is to reduce them. Coase (1988) also identified firms, the market and law as alternative institutions and modes of coordination for minimizing transaction costs and this observation opened the way for new institutional economics (NIE).

NIE comprises different approaches to contracts and organization. The vast literature based on NIE ranges from agency theory (principal – agent) to studies on property rights. NIE is comprised not only of economic but also multidisciplinary studies combining legal, political, and social approaches with economics (Shelanski and Klein, 1995). NIE studies the contract as business behavior from the institutional and organizational perspective. Utilizing the concept of transaction costs, Oliver E. Williamson approaches contracts as business governance methods. His continuum of governance methods ranging from hierarchy (organization) to market (discrete contracts) is nowadays a widely used framework for studies of contracting and networks. Asset specificity, uncertainty and frequency of contracting are of primary importance when companies choose their governance mechanism in reducing transaction costs (Williamson, 1985). Williamson applied the concept of bounded rationality from Simon (1997), suggesting that the choices that businesses make are intended to be rational, but only relatively so. The lack of high costs of information or knowledge always hinders rational choices. Similarly, North’s (1990, 2005) studies of institutions suggest that rationality is significantly bounded by informal institutions, including attitudes and working habits, which change more slowly than formal institutions, such as the law and official contracts.

Williamson also applied Macneil’s (1978) relational contact as the legal basis for his governance models (Williamson, 1985). Williamson’s approach to business contracting, however, differs from Macneil’s ideal, which requires cooperation. Williamson believes that some amount of opportunism is always present in business and should be prevented by binding the cooperating parties. Based on asset specificity, relation specific investments are one method of binding parties in cooperation. Asset specificity is applied, e.g. in supply chains and networks where suppliers decide to specialize in particular
requirements of the client and thus become dependent on it. Creating a joint project can also be seen as temporal specificity and an attempt to bind the interests of the parties together.

Williamson and transaction cost economics have produced a great deal of research, both in theory and also empirically. For example, there are some empirical studies on asset specificity and contract-based coordination (Artz and Brush, 2000; Buvik and Haugland, 2005). At the same time, it generated criticism leading to a new path for behavioral studies of contracting. Rare empirical studies on contracting on this path are based on organizational and strategic management research (Argyres and Mayer, 2007; Eckhard and Mellewigt, 2006). For example, Argyres and Mayer (2007) studied contracting as organization learning process and thus bridged the gap in the Williamson’s (1999, pp. 1103-4) transaction cost economics. They propose this learning as part of organizational capabilities (Williamson, 1999), which can be developed as contracting capabilities (Argyres and Mayer, 2007). Argyres and Mayer’s (2004) empirical contribution connects various existing literature on organizational capabilities, which defines capabilities as a unique capacity of a firm to allocate resources (Teece, 2007) to the study of business contracting. Furthermore, Eckhard and Mellewigt (2006) defined different functions of contract terms, and highlighted the interplay of hard elements with the safeguarding function and soft elements that function to prepare firms for contingencies and to organize cooperation.

Bounded rationality, the capabilities perspective and organizational learning provide rich insights for a multidisciplinary study of contracting as a process, with hard and soft elements as a tool for analyzing contract terms. This is in line with the claims made by Nystéén-Haarala (1998) and in Deakin and Michie (1997). In particular, in her dissertation, Nystéén-Haarala highlighted the need to approach “contracting” empirically, as a process, not just as a contract document or contract law. This was due to the differing logic of contract law and contracting practices. While courts and contract law may regulate contracting as an *ex post* matter, *ex ante* consideration can also be brought into contract law. Courts may acknowledge and enforce soft elements of a contract, and utilize dynamic substantive contract law principles (Annola, 2003; Lehto, 2008). However, these are not limitless (Nystéén-Haarala, 1998, pp. 244-51, 2008, pp. 18-21) and the insights from NIE and organizational studies can complement the logic of contract law with that of contracting practices. In other words, there is a need to combine the two streams of contracting studies that we have presented above. A more comprehensive picture of contracting needs to consider both the perspective of organizational learning and capabilities and examine the interplay of hard and soft elements in contracts as contracting tools.

3. Research project

3.1 Contracting – a broader approach to contracts

We combine the above insights in two ways. First, the aim of our previous project based on empirical studies was to incorporate the capabilities perspective based on organization studies into the study of the contracting process (CCC Project Final Report, 2008). Second, based on the findings of the research project, we use hard and soft contracting as conceptual tools to analyze actual contract terms and contracting behaviors.

The CCC project identified elements of contracting capabilities. The first step to building CCC is to acknowledge contracting and business process as closely interlinked
processes. As Figure 1 shows, both from the perspective of the buyer and the seller, the contracting and business processes are closely connected, from the beginning until the termination or renewal of the project and contract. When contracting is viewed as a process, in addition to the preparatory and commitment stages, the execution of contracts is an important part of the contracting process. While Figure 1 is based on a simplified process of the sale of goods, a different business model would lead to factually different but similarly interlinked processes.

The vertical dashed line in the center of the figure represents the moment when the contract is signed. This moment in both jurisprudence and business practices is often narrowly understood as contracting itself. Sometimes business people also regard only the contract document and the written appendices, such as technical specification as the contract. Business lawyers, however, know that besides this visible and explicitly documented part, the contract includes invisible, implied parts such as trade customs and practices between the parties, as well as mandatory legislation and default rules. This invisible part of the contract may affect the stipulations of the written documents unexpectedly filling the gaps in the visible documents (Haapio, 2004).

The concept of “contracting”, which the CCC team applied is even wider than the visible and invisible parts of contract. This research applies the concept “contracting” as the entire process from the planning phase to the successful end of cooperation. Contracting already starts when production or the scope of the offered services is being planned. Contracting includes sales and procurement strategies and contacts between the parties before actual contract negotiations have even started. Contracting does not end in signing the documents, but continues through controlled and well-coordinated implementation of cooperation till the well-managed end of the project. Good contracting also deals with efficient feedback from implementation to sales or procurement planning. Using this broader definition of contract and the process-based perspective of contracting; a contract can be understood as a framework for a changing and developing relationship. Firms can harness contracting capabilities by identifying their current

![Figure 1. Contracting and business processes](source: CCC project final report)
contracting process and the capabilities of the organization and by aligning them with their business processes.

3.2 Description and objectives
The CCC project grew out of the need to fill the gap in research by identifying CCC and examining the means of aligning them with business goals. The research consortium was formed from both academic and business lawyers as well as firms.

The objective of the research project was two-fold. First, from the theoretical standpoint, the research project aimed at identifying elements of contracting capabilities and methods in integrating them into the strategies of new business models such as partnership, network, and life-cycle. This exercise also sought to propose ways of fully utilising the CCC found at different levels of organizations. Second, the empirical part of the research sought to determine how different business models affect contracting and contracting capabilities and how firms configure them in new business models. In combining these two aspects, the research project aimed at examining if and how contracting capabilities could be developed into a competitive advantage.

The research project was carried out in close cooperation with eight Finnish corporations whose business projects were observed from the planning stage to implementation, close-out, and assessment. The companies represented different branches of industry and trade. Three of the companies produce machinery or production lines and sell services, service solutions and project management connected with machinery, which they or other companies have produced. One company represents chemical industry, one plastic industry, one children’s playground production and one is in food and restaurant business. One company was established to run a special construction project. Typical for all the companies was that they were going on a change; either they aimed at increasing the share of services in their sales, were considering different models of business and contracting or they intended to establish into new markets. All companies had understood the value of contracting and wanted to develop their contracts.

We decided to focus on contracting in the life-cycle business model, as there seems to be a growing demand for this from industry. Life-cycle business could be understood in many different ways, since it is not an academic concept but applied in business practice with every company defining it in its own way. In this study, we defined the life-cycle business model as model, which sought to provide the extension, renewal, addition and sometimes creation of values for the benefit of customers, often but not always tied to sold tangible products. Examples are the sale and provision of maintenance services, service packages and solutions, and performance solutions suited to industrial products and customer processes for the entire life-cycle. The final report of the CCC research project focuses on the kind of contracting life-cycle business requires and the challenges companies face in shifting to life-cycle contracting (CCC Project Final Report, 2008). Additionally, all eight companies got a confidential company report, which focused on contracting issues that are important for them.

At the outset, the research group identified and created a typology of contracting capabilities in three different overlapping forms of organizational capabilities or learning: contract contents, contract process, and relational capabilities. Contract content capability is at organizational learning or capacity related to both the visible part of the contract such as the documented data, and the invisible elements of the contract content, for example, the mandatory and default rules, trade customs and business practices of the parties (Haapio,
Contract process capability deals with organizational capacity or learning on how to manage all the processes related to contracting, i.e. drafting, solicitation, execution, adjustment, and follow-up of contracts. Relational capability is the organization’s capacity to create, manage, and maintain contract relations.

Contracting for the life-cycle business model presents a unique challenge to the hard contracting approach as there is a clear need to align the interests of the buyer and seller, and, as the term suggests, contracting is based more on the continuous relationship of both parties rather than a collection of discrete contracts. At the same time, the uncertainty that may not be anticipated in such projects needs to be considered in the contracts as well as contracting processes. If the existing contracting capabilities of the firm as such are developed on the basis of the hard contracting model, and if they are followed rigidly, we could predict would be created particular challenges in the aims of the firms in shifting their business model to life-cycle business. This study examines these challenges.

3.3 Methodology

Applying the triangular method, three types of data were gathered – from interviews, documented materials and literature. A comparison of data from these sources of the same research subject matter allowed us to form a comprehensive and multidisciplinary picture of contracts and the contracting behavior of firms.

We gathered empirical data from eight Finnish firms, based on loosely structured or thematic qualitative interviews. The firms are active in international operations but their fields of business, core competences and size varied greatly. They were, however, in the midst of shifting their business models in response to changing market dynamics. Depending on firm size, one to 11 key persons involved in contracting in each organization were interviewed, and we conducted a total of 60 interviews. To collect a complete dataset, interviewees included not only lawyers, but also managing directors, administrative directors, regional managers, construction supervisors, project managers, and research directors. Most interviews were taped with the permission of the interviewees (Table I).

We also gathered documentation relevant to the descriptions and identification of the firms’ current contracting capabilities. These included the contract models and templates currently in use, active contract documents and appendices, contracting review checklists, policy documents such as instructions and manuals, sales materials, models and maps, and marketing materials.

<table>
<thead>
<tr>
<th>Company</th>
<th>Persons interviewed</th>
<th>Total duration of taped interviews</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>6</td>
<td>7 h 2 min</td>
</tr>
<tr>
<td>II</td>
<td>8</td>
<td>7 h 40 min</td>
</tr>
<tr>
<td>III</td>
<td>6</td>
<td>9 h 1 min</td>
</tr>
<tr>
<td>IV</td>
<td>3</td>
<td>6 h 38 min</td>
</tr>
<tr>
<td>V</td>
<td>3</td>
<td>8 h 8 min</td>
</tr>
<tr>
<td>VI</td>
<td>1</td>
<td>1 h 6 min</td>
</tr>
<tr>
<td>VII</td>
<td>8</td>
<td>12 h 15 min</td>
</tr>
<tr>
<td>VIII</td>
<td>1</td>
<td>1 h 49 min</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>34</strong></td>
<td><strong>53 h 39 min</strong></td>
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</tbody>
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Table I.
These two types of data were analyzed using the typology of contracting capabilities described above (contents, process, and relational capabilities), and in the light of contract and contracting theories from the literature.

4. Research results and industrial impact
The shift from sales of tangible goods to life-cycle contracting requires many changes at all levels of contracting capabilities and a different mix of hard and soft contracting elements was found.

4.1 Research results
4.1.1 Contract contents capability. Firms seem to face most challenges in terms of contract contents capability. Firms that commonly apply recommended standard contracts either directly to their business or devise their own templates were faced with the absence of such recommended standard terms in their new business area or found standard terms inadequate. Two factors may explain this absence or inadequacy. The very newness of the business model means that standard terms could not yet have been developed. At the same time, the importance of assessing and developing contract models and tools at the early phase of productization is magnified. However, as the business model requires more data and in-depth information from customers and customization, contracting may also need to develop in a case-specific manner. As a result, standardization becomes difficult. For example, it is more difficult to standardize service business than the sale of goods, since service contracts tend to require tailor-made terms.

Shifting the business model may also indicate a shift in the actual terms of contracting and their functions—hard and soft elements. According to Eckhard and Mellewigt’s (2006) study, on the automobile business in Germany, we may predict that in the shift to life-cycle contracting, the amount of clauses concerning flexibility and coordination would increase proportionally, compared to safeguarding terms. This may suggest that life-cycle contracting would include softer terms of contracting.

Our empirical study, however, did not find any such shift. This was because, first, it was difficult to qualitatively divide contract terms according to function. One clause may contain several elements of contractual functions. Quite often coordinating functions are not separated as own clauses, but may be combined with safeguarding, and clauses dealing with contingencies include also safeguarding. Second, it seems that safeguarding functions, however, proved to be important, since the seller’s risks grow in life-cycle business. We also noted that the means of safeguarding change. In other words, we found that the terms used to safeguard the sellers’ risk were substantively different in life-cycle business models. For example, in some cases, contracts did not contain any limitation of specific liabilities or specific warranties. Instead, performance-based guarantees were used. Such guarantees define the scope and the goals of the contract as specifically as possible in order to define the liability of the service provider, who promises to guarantee a certain level of services. This may superficially seem to reduce the safeguarding function in the contract. However, key performance indicators as well as the pricing structure functions as a means to safeguard the risks. Additionally, as the business model changes, the nature of the risks also changes. For example, in service contracts, the business model generating the value and the scope of contract could be based on variables such as task, outcome or performance. Depending on the variable, firms used different means to safeguard
the risks. In most firms, the transition from one business model to another was not complete, and the contracts displayed a mixture of terms some reflecting the sale of goods with a traditional limitation of liabilities, and others reflecting life-cycle business.

Contrary to our prediction that flexibility would be dominant and softer elements used more in these contracts, flexibility was not very clearly shown in the studied life-cycle contracts. This may be explained, first, by the fact that firms were still in a transitional phase. However, there are also other explanations related to the contracting model that the law and contracting professionals use. There are insufficient examples of change mechanisms, because in the sale of goods and according to the classic contract law perspectives, contingencies are an exception. In contrast, in life-cycle business models, contingencies are the rule. However, firms seem to customarily employ open renegotiation clauses, which only require the parties to negotiate in case of contingencies. Another observation was that the duration of the contract was strongly dependent on customer demands and the cost of relation-specific investments. Firms used longer-term contracts when the cost of relation-specific investments was high with a relatively new customer or in a new market. In a more established relationship, firms used relatively short-term life-cycle contracts and utilized contract renewals as an element of flexibility.

This complements the findings of Poppo and Zenger (2002) that firms may deliberately assign contingencies and their mechanisms to relational capability. Hence, if firms have a superior relational capability, in comparison to their contract content capability, they may opt to govern the contingencies by relational capability. Thus, firms may benefit from designing models with mechanisms for change when contracting for life-cycle business; this reflects their relational capability. This is due to the fact that documentation allows firms to benefit from organizational learning. Creating flexibility mechanisms in contract documents represents “soft contracting,” which takes relational aspects of contracting into account. This approach also supports the use of the contract as a tool for managing the relationship.

The shift in contact terms is presented in Table II which shows the International Association of Commercial and Contract Management’s (IACCM) view on how contract clauses will change in the future. The clauses of today have been collected with the IACCM’s early survey of 2008 from its member companies showing which contractual terms their negotiators regarded as the most important in their contracts. Those terms still present a typical sale of goods approach with limiting seller’s liability and indemnifications. In life-cycle and service business, the buyer has to take more

<table>
<thead>
<tr>
<th>Top ten today</th>
<th>Top ten in the future</th>
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<tbody>
<tr>
<td>1 Limitation of liability</td>
<td>Scope and goals</td>
</tr>
<tr>
<td>2 Indemnification</td>
<td>Change management</td>
</tr>
<tr>
<td>3 Price/charge/price changes</td>
<td>Responsibilities of the parties</td>
</tr>
<tr>
<td>4 Intellectual property</td>
<td>Communications and reporting</td>
</tr>
<tr>
<td>5 Confidential information/data</td>
<td>Service levels and warranties</td>
</tr>
<tr>
<td>6 Service levels and warranties</td>
<td>Price/change/price changes</td>
</tr>
<tr>
<td>7 Delivery/acceptance</td>
<td>Delivery/acceptance</td>
</tr>
<tr>
<td>8 Payment</td>
<td>Limitation of liability</td>
</tr>
<tr>
<td>9 Liquidated damages</td>
<td>Dispute resolution</td>
</tr>
<tr>
<td>10 Applicable law/jurisdiction</td>
<td>Indemnification</td>
</tr>
</tbody>
</table>

Table II.
Top ten contractual terms

IACCM 2009
responsibility and define it in the scope and goals of the contract. Traditional limitation of liability cannot fulfill the requirements of client-based service business. We agree with the IACCM on the way, which contract terms will change. The IACCM members seem to be in a similar transition process as the companies of our empirical study (Contracting Excellence IACCM Newsletter, 2009). According to the CCC findings, contract contents had not only strong elements of the traditional hard approach, but also included new soft elements. Such a mixture shows an ongoing transition as well as confusion in approaches to contract.

4.1.2 Contract process and relational capabilities. Firms seem to understand the importance of contracting process capability. Several firms employed well-documented and standardized processes, such as computer-based programs controlling every step of contracting. Some companies present their contract policy as written instructions on how to file the documents and who has to check what in which phase of the contract process. Standardization becomes more important as the firm grows larger and with a larger number of people participating in contracting. This can be explained because intra-organizational coordination may become more important in a larger firm. Standardization can, however, also be carried too far and lead to a danger of the process becoming too rigid. From this perspective, it is also important to assess the influence the models and templates used by the company have on the contracting process. The role of lawyers also proved to be complicated in the contracting process. If there are no lawyers participating, important contents may be omitted. On the other hand, a legal department may also hinder contracting, because the lawyers are brought in too late to change the situation. In some situations, a different corporate negotiation culture and a lack of familiarity with the soft elements required in contracts for the new business model hindered the lawyers from actively drafting flexible terms.

Our empirical data confirmed that in most cases firms hold a narrow view of contracts and the contracting process along the contract conclusion line in Figure 1. Often companies seem to regard contracting process as starting from sales negotiations, but do not see a connection of contracting with planning the products or scopes of services. Second, even when contracting process capability is acknowledged in the firm, and contract design and negotiation are smoothly managed, implementation or execution of the contract needs to be included in this process. Feedback from implementation to planning is too often not working properly. In life-cycle contracting, it is typically the implementation or execution of the contract which requires flexibility and mechanisms for change. Furthermore, in life-cycle business contracting, contract execution would require additional cooperative contracting process capability management, from both parties. Thus, managing of the contracting process is closely tied to relational capability.

Relational capability is always extremely important in managing contract processes, but in life-cycle business, which is more customer oriented, the significance seems to be magnified. This is because more attention should be paid to customer selection, communication processes, and customer relations management, before, during, and after the projects. This also means that relational capability needs to be developed as a process with a documented operations policy covering the entire organization. Leaving the management of contingencies to personalized relational capability, such as good negotiation skills, may not always be recommendable. However, organizational capabilities function at different levels of the organization but are dependent on
personal skills. The empirical data showed that firms found that a change in the contact person could ruin a well-built relationship and common understanding. One sales person said: “Several times it has happened that we spent a lot of time building a good relationship with the client, and when everything works properly, the guy leaves the company or is moved to another position, the new guy starts to read the contract word by word and refuses to recognize earlier agreed practices.” The same complaint was mentioned in several companies. This could be interpreted as indicating that the relational capability of the organization remained at the personal level and has not transferred to the organization. Documented policies and other forms of standardized practices transfer such skills and knowledge since organizational capability is important in the relational aspects of contracting.

4.2 Implementation and exploitation

Unpredictable contingencies in long-term and life-cycle contracting seem to demand flexibility. However, flexibility presents a challenge to contracting. While it requires a softer approach for contracting, softer elements may be incorporated into the contracting without necessarily exposing firms to risks or creating a high level of unpredictability in the contract. When contract documents are complemented by the contracting capabilities of a firm, it is possible to view contracting as a framework for handling contingencies, disputes and different understandings, relationally.

As discussed above, firms can incorporate flexibility into contracting and contract documents in various ways. Most obviously, firms can use soft terms such as renegotiation terms in the contract documents, thus providing the parties with mechanisms to handle contingencies, agree to agree later, or agree to institute an organizational process for specifying and defining the principles or references for supplementation, and to change contracts under certain circumstances. However, soft elements do not necessarily have to be incorporated into contracting through the use of soft contract terms. Flexibility can be incorporated into the contracting process by utilizing contract process capability based on well-understood policies or relational capability. However, relational capability must be managed at an organizational level, because relational aspects may become linked to personnel. Soft contracting does not mean personalization of the commitments of the organization.

Aligning of contracting with the corresponding business model is a challenging task. We suggested here that understanding contracts and contracting as a process is necessary and especially so in the transition to new business models. In terms of life-cycle contracting, the phases before and after the conclusion of the contract must be emphasized. This highlights the importance of the proactive development of contracting capabilities necessary in different business models and in different phases of the contracting process. This is partly because developing rules and customs that form the invisible but important part of the contract takes time and demands input from the contracting practices. Thus, uncertainty would demand of businesses a proactive development of contracting capabilities. Life-cycle contracting seems to be one such example where there are more uncertainties in the legal context. In other words, firms should invest in soft flexible contracting, to save time and the costs of court disputes. In this way, contracts may be applied as tools for implementing business strategies and risk management.
5. Conclusions
Creative and innovative changes in businesses have always challenged how the law regulates contracts and market-based exchanges. We have examined here a case where the life-cycle business model challenges conventional contracting practices and contract law based on hard and precise contracting elements. If developed under the hard contracting approach, contracting capabilities may fail to be useful in a new business model requiring flexible management of contingencies. Flexibility and soft relational aspects of contracting should be understood as contracting tools and need to be incorporated in a way suited to the business model in use.

A study on contracting capability needs to be based on empirical data and additional empirical research is needed to find out more about how capabilities are applied and how they can be developed. Our work goes on in a R&D project studying cooperation of companies in innovating together. In the future, we aim to focus on different business sectors managing international project and trying to support their work in producing flexibility clauses for various business models. This study has been one of the first contributions to bridge the gap in the literature. A comprehensive theorizing of contracting capabilities requires further enquiries into business practices as well as how courts may treat soft elements of a contract and contracting. Empirical contracting studies can help those working with contracts and managing business projects as well as those contributing to alternative dispute resolution.

There are, however, a lot of challenges in producing scientifically verified results. First, there is no objective definition of good contracting practices. For instance, attitudes towards documenting and standardizing practices differ greatly. Another example is the way how companies see the role of lawyers in contracting; often contracting is considered to work properly, when lawyers are kept out of the process. We represent, however, the opinion that lawyers should be working together with other professionals as closely as possible. The need for cooperation is not always appreciated in companies, and the nature of good contracting seems to be a matter of opinion. Furthermore, companies are often reluctant to learn from their mistakes. They even tend to hide failures and refuse calculating the losses of failures. Therefore, the value of efficient contracting is not always recognized.

Given that court practice and law generally take time to develop, we recommend that firms develop internal organizational contracting capabilities in order to use bilateral governance methods and learn to apply and combine hard and soft elements of contracting. Future research depends on the firms’ acknowledged need to develop their contracting practices. We see an increasing interest in business in this respect.

6. Acknowledgements
The authors thank the financers: the Liito program of the Finnish Funding Agency for Technology and Innovation (Tekes) and the Liike2 program of the Academy of Finland. Tekes funded a research consortium “Corporate Contracting Capabilities in Business” of universities of Joensuu (now University of Eastern Finland), Helsinki and Lapland and a parallel project at the Turku University of Applied Sciences (2006-2008) and the Academy of Finland a project at the University of Joensuu “Corporate Contracting Capabilities in Companies” (Grant Number No. 112085 (2006-2009)). The project continues in part through a research group “Intellectual Property in Open Business Models” (2008-2011), a joint project with the VTT Technical Research Center
of Finland in Tampere and the University of Eastern Finland, financed by the Tekes Liito Program.

Warm thanks goes to Ms Helena Haapio, LLM, MQ and contract coach at Lexpert Ltd and Mr Matti Urho, the former vice CEO of Shering/Leiras and now a management consultant of Partisan Ltd for their advice and comments during the research process. The authors also want to thank IACCM Finland and Project Management Association Finland for their contribution and support.

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**Further reading**


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