Penny-Anne F Cullen and Richard Hickman (2012)
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Contracting *Lean Construction Journal* 2012 pp 49-60
www.leanconstructionjournal.org

Conflicts Between Contract Law and Relational Contracting

Penny-Anne F Cullen[1] and Richard J. Hickman[2]

Abstract

Hypothesis: Contracts undermine the efficiency gains that parties to major projects intend from their working relations.

Purpose: The paper focuses on the potential conflict between the interpretation of contract law from its Common Law base and relational contracting. In particular, the character of the English Common Law of contract is briefly analysed. Comparisons are then made on several recent cases which embody the Common Law interpretation in informal relational style agreements. Conclusions are drawn onto how the relational concept can be safely embodied into contract.

Research Design: The study reviews the theory of relational contracting with reference to fundamental Common Law doctrines, which are illustrated with legal precedents

Findings: Enduring Common Law concepts of laissez-faire and freedom to contract represent a historical hangover. It is therefore important that the construction industry, as well as sectors that represent other multi-party contracting environments, focuses on how the contract might support, rather than impede contemporary contractual relations.

Limitations: The combination of the authors' previous industrial and academic experience has proposed this preliminary study.

Implications: The proposals to empirically evaluate and extend the ambit of the study has a positive economic impact on the construction industry, together with others practitioners who are lawmakers, contract lawyers, as well as professionals in both the public and private sectors who are involved in contracting.

Value for practitioners: a foundation for empirical studies that will support and provide an impetus for practitioners and lawyers who are committed to reap the efficiency gains that are available if relational contracting is embodied in legal as well as aspirational terms.

Keywords: Relational contracts, trust, relationships, uncertainty, good faith, contract law, transactions.

Paper type: Case Study

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Introduction

The concept and performance of a "contract" means different things to different people. The perception of the exchange will depend, although not entirely, on their legal system, vocational experience, profession and culture. However, at a fundamental level the contract will either be "complete", in which the whole nature of the transaction is fully described, or "incomplete" in which certain elements of the transaction cannot be fully defined in the contract itself. In a "complete" contract all the elements of the transaction are fully understood, all rights and duties are prescribed and is therefore fully supported by contract law. For simple products and services the encapsulation of the contractual details is straight forward, practical and effective.

However, complex products and long term projects have inherent uncertainties; for example cost fluctuations, unknown ground conditions or the development of a new design concept. Therefore, each uncertainty carries a financial risk and in order for the contract to reach the desired state of being "complete" the risk has to be allocated between the parties. Allocation of risks opens a Pandora's Box of negotiation tactics, which can include economic duress and opportunisium. The outcome in the long term leave the parties either dissatisfied with the contract or burdened with the administration costs of refuting claims.

An alternative, which is one of the tenets of relational contracting, is to accept that the contract is "incomplete" and the risk elements that will eventually be encountered are resolved between the parties in a timely way.

However, this seemingly simple and amicable logic presents fundamental problems to the Common Law system on which the majority of contract law is based. First, relational contracting assumes a commitment by both parties of reciprocity and good faith in the conduct of the transaction and in resolving the risk elements. However, it can be argued that this concept is at variance with the Common Law presumption that an adversarial relationship will ensue and the parties need the protection of the contract to resolve problems.

Second, in a dispute the court can reject the intention of the contract and return to the Common Law and interpret the contract strictly in these terms.

Therefore, under these conditions, should matters come to court; a relational contract can be viewed with a higher degree of uncertainty than the more traditional forms of contract. This argument has been used by many organisations in rejecting the relational form for long term projects. This paper follows the lines of these arguments and considers a number of provisions that can be adopted to ensure the principles of relational contracting are followed.

This paper refers to investigations into contractual relationships formed in complex industrial projects that were the focus of the ECLOS (1999-2001) and LoTISS projects (2002-2005) and Hickman (2009). It also considers contracting principles from the socio-legal basis that is referred to by Macneil (1974) and Campbell (2001) as "relational contracting". The discussion commences with an overview of the legal perspective of contacting in Common Law[3]. The paper also considers the impact of the form of contract

3 Other legal systems differ from the Common Law and therefore they are beyond the boundaries of this paper.

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on the parties' intended relationship and its potential effect on the transaction costs of the project.

From these propositions an assessment is made on how parties to construction projects intend to work together and whether or not this aligns with the formal contract terms to which they are legally bound.

In conclusion, this paper offers issues on the adaption of the relational contracting theory to construction industry practice. Directions for future research are also identified.

A View on the Law of Contract

The Common Law concept of a contract is an agreement to which the parties intend to be legally bound. This seemingly simple statement encompasses a plethora of intertwining rules and doctrines that govern how contracts are agreed, formed, performed and terminated. The conduct of the parties during the transaction and how to conduct any post termination issues that arise are established by a governance structure set out in a collection of terms and conditions.

Agreement

The first premise is that we are all free to enter, or not, into a contract. There are provisions of course; however, the notion of "free" is often distorted. The convenient assumption that parties were free to bargain was based on the premise that people would only negotiate terms that reflected their interests was established during previous industrial eras when the laissez-faire philosophy and the freedom to contract movements were in vogue. In reality, a laissez-faire and market led society allows one party to negotiate economically advantageous contract terms over any weaker party. The employment and trading conditions imposed by the Victorian hierarchy on the disadvantaged working class clearly illustrates this philosophy in practice.

Therefore, the Common Law is predicated on preserving the status quo, with the party holding the initial balance of power maintaining its dominance throughout the transaction. The historical hangover of the Freedom to Contract movement (Cullen and Hickman 2007) remains at the roots of the Common Law of contract, which permeates how contracts are negotiated, drafted and managed[4].

Formation of the contract

The form of the contract, or its governance structure, is a collection of implied and expressed conditions on how the contract is to be performed. Whilst express terms may be either written or verbal terms may also be implied through the parties' conduct, representations, past dealings, legislation and commercial practice.

Therefore, as Brownsword (2000) contends that contract drafting and new case law attempts to adapt the original doctrinal foundations of the law of contract based on Victorian values to a wide variety of contemporary business practices and circumstances.

4 The Common Law system of judicial precedent is founded on a hierarchical structure, with decisions that emit from higher courts binding lower ones. Moreover, as judges' decisions must be based on decisions from previous cases, the prevailing rules of the law of contract are influenced by the historical Common Law presumption of contract relations being adversarial.

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In practice a sensible approach is to employ a suitable form of standard terms and conditions to the transaction. If the temptation is avoided to substantially modify these documents a standard form offers a fair form of agreement that should not conflict with the Law of Contract. These popular forms also allow the parties to familiarise themselves with their rights, duties and the day-to-day operation of the contract. However, the current escalation of standard forms on the Internet for almost every type of commercial activity available now adds to the confusion. As a result, recently a public authority was encountering hundreds of standard forms in the course of its activities. Thus, somewhat defeating the objectives of employing a recognisable form of contract.

Performing the contract

The common approach in performing the contract is to divide the parties' obligations into separate operations, with each organisation working to their individual objectives. The transaction is discrete and self-contained between the parties with only inter-action being at the interface of the project. The purpose of the contract is to protect the parties from each others' opportunistic behaviour by developing a "complete contract" that is enforceable by the courts.

Although the parties can accommodate known or anticipated risks in the transaction, there is what Williamson (1985) calls "uncertainty" which consist of "external vagaries". These relate to typical force majeure[5] conditions in a contract that provide for events that affect the transaction that are completely outside the control of the parties. The contract is effectively suspended until normal circumstances resume. Therefore, both parties must act to reduce the effects of suspension, but cannot claim any damage or loss as a result of the event.

However, in the event of breach, the courts provide compensation or damages. Unfortunately the process of obtaining satisfaction through the court system is clearly time consuming and costly. To circumvent these difficulties it is normal practice to introduce a liquidated damages clause that provides for a mutual assessment of the probable damages that a delay or breach would cause.

However, liquidated damages can be considered as a threat that is held over the other party as a security that the contract will be performed[6].

Termination and dispute resolution

The practice of having disagreements resolved through forms of alternative dispute resolution (ADR) is gaining in popularity. This trend towards avoiding costs and the unwelcome publicity from litigation continues to concur with the findings of Beale and Dugdale (1974) that in the event of contractual disputes, opposing parties negotiate as if they were governed by the rules of court procedure. Cullen (2005) suggests that in contrast to the formal traditions of litigation, when a relational contracting model is adopted the risks of disputes diminish because the parties have incentives to share information to protect their mutual interests. In the event of an impasse, the parties can elect for ADR, such as mediation, arbitration or adjudication.

[5] From the French an irresistible force or compulsion that is beyond the control of the parties

[6] However, if the sum is disproportionately more than the actual damages that could be incurred the delay, the amount can be considered as a penalty and can be rejected by the court.

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In order to illustrate a potential area of conflict decisions from the courts, the following section considers four significant cases that demonstrate issues of legal uncertainty with respect to informal arrangements.

Uncertainty in the courts on contract disputes

The material facts, summary of the evidence, applicable law and the judgments of the cases selected can be found in the law reports and are referenced in the footnotes. The cases were all decided in the English courts over the decade, spanning from 1991 to 2002. The common element in these cases is that the contracts between the parties did not formally express the established practice in legally recognised terms. The cases that are the focus of the viewpoint are as follows:

- *Williams. v Roffey Brothers and Nicholls (Contractors) Ltd*[7]
- *Re: Selectmove*[8]
- *Watford Electronics v Sanderson*[9]
- *Baird Textile Holdings Ltd v Marks & Spencer Plc*[10]

In *Williams v Roffey*, the court recognised the parties' flexible arrangements; whereas the decision in *Re: Selectmove* reinforces the primacy of the adversarial presumption of laissez-faire contracting. In *the Roffey case,* the court held that in the absence of evidence to show that there had been economic duress by either party, the parties had agreed to vary their original agreement, which was to the mutual benefit of both parties. On the facts of the case, the court held that the parties had renegotiated their obligations, which facilitated the construction work being completed on time by the sub-contractor. This arrangement had been varied between the parties to avoid the main contractor having to pay damages to its client for breaching the main contract.

In *Roffey*, the court upheld the parties' unwritten agreement to amend the original terms in response to changes that they had not foreseen when they had agreed their original contract. The Roffey decision heralded a flurry of interest in the legal and construction community because it appeared to give legal effect to a customary UK construction industry norm, for contracting parties to flexibly vary the original agreement to ensure that the programme is completed on time, avoiding liquidated damages for late completion (Cullen, 2005).

However, the construction industry's optimism in the Roffey decision was short lived.

In *Re: Selectmove* (1995), the court declined to widen the ambit of the *Roffey* decision to circumstances where the court perceived that there was insufficient evidence of an agreed variation in the parties' original agreement. Subsequently, the primacy of classical contract law, which was upheld in the *Selectmove* case, was re-emphasised in *Watford Electronics v Sanderson* (2001).

In the *Watford* case, the court held that the original contract terms could not be varied subsequent to their initial agreement. In this case, the court considered that there was no evidence that any new consideration had been provided to support the variation.

7 [1991] 1 QB 1 (CA)
8 [1995] 2 All E R 531 (C.A.)
9 [2001] 1 All E R 296
10 [2002] 1All ER(Comm) 737

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On this basis, the court decided that the original terms were still valid. The court had followed *Re: Selectmove* and not *Roffey's* and appeared to undermine the parties' consensual variation of their original terms.

In assessing how contract law underpins contracting parties trust and confidence that their respective obligations will be completed, the decision in *Baird v Marks & Spencer Plc*. (2002) considered legal certainty in relation to implied terms. The following summary is based on the law report[11].

In essence, the facts were that Baird Textile Holdings Ltd (Baird) had supplied clothes to Marks & Spencer (M&S) for some thirty years on an annual cycle. However, M&S announced without warning that they were terminating their relationship with Baird. The supplier sued M&S on the grounds that it should have been given reasonable notice, although there was no express contract under which such a term was detailed. Baird argued that a contract should be implied through their course of dealings. The trial judge found that no such contract existed. Baird appealed, citing evidence to show that M&S had implicitly promised that it would place annual orders on a seasonal basis. This arrangement, which was contingent on the supplier's agreement to comply with specific requirements, was not contested by M&S.

The Court of Appeal's judgment was handed down in favor of M&S. Essentially, the basis for the decision was that the formal requirements for a legally binding contract were not present and that Baird's representations[12] were insufficiently certain in legal terms to prove its claims against M&S.

The issue of legal certainty is an important factor if the parties intend that a relational style of agreement is legally binding. In the case of *Baird v M&S*, the terms "unreasonable" and "long-term" could neither be proven according to the laws of evidence nor supported within the confines of judicial precedent. Therefore, as Brownsword (2000) and Collins (1999) maintain that, for the avoidance of doubt, if words that the law of contract might construe as being precatory and uncertain, such "fairness", "amicable" and "good faith", they should be clearly defined in the written agreement. Furthermore, Cullen (2005) recommends that formal procedures be agreed for the parties to reach a consensus on any issues.

The foregoing lines of judicial decisions illustrate that the burgeoning hydra of contract law engenders uncertainty in both legal and business communities. The reason for the obfuscation is when courts apply established judicial decisions to a case the system of judicial precedent provides opportunities for judges to distinguish previous cases in order to apply them to contemporary circumstances. Therefore, rather than having a clear system of rules, there are conflicting legal decisions, which potentially can apply to any given case by the courts.

As Beale and Dugdale (1975) found that the law of contract engenders uncertainty regarding the outcome of a case it is unsurprising that the parties tend to refer to courts

11 In essence, a law report summarises (1) material facts of the case; (2) law that applies to the facts and then (3) makes a decision and explains the reasons for the decision ("ratio decidendi") based on numbers 1 and 2. If the law report relates to a court that is superior in the hierarchy, such as the Court of Appeal as in Baird v M&S, the case becomes a precedent that could affect later cases that are brought before the courts.

12 Q.v. passim representation by estoppel in McKendrick E (2005) « Contract Law : Text, Cases and Materials », Oxford University Press, 2nd ed, 250-251

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as a last resort. Consequently many contemporary issues related to contract are unlikely to be publically aired. In this context Brownsword (2000) suggests that the law of contract tends not to synchronise with contemporary business practice and the parties vary from contract law at their peril. However, the relational form of contract has gained popular support in construction and the basis for potential adoption into working contracts is reviewed.

Relational contracting in construction

Macneil (1978) refers to relational agreements as an alternative to the classically grounded transactional contracting perspective of contracts as being the formal, express agreement that attempts to predict in detail what uncertainties will arise.

According to Macneil, relational contracting creates contractual communities, which embodies a fundamental assumption that unforeseen events are inevitable and are mutually resolved between the parties during the project.

In a similar vein, other acknowledged research by Macaulay (1985 and 2007), Beale and Dugdale (1975), Beale, Bishop and Furmston (1999) analyse the relations between companies that combine collaboration with the continuing use of formal contracts that may be little more than a series of simple purchase orders.

Other lines of research by Macneil (1978) and Deakin, Lane and Wilkinson (1997) expand this theme to suggest that contractual relationships are evolving, discrete societies that contain their own system of internal norms. Their informal traits are combined with, the parties' previous trading history, reputation and trade customs, as well as the formal rules that are embodied in the written contract. These norms are supported by the parties' specialist knowledge and experience.

The following Table 1 presents Macneil's relational contracting principles in the context of construction issues.

Macneil's theory supported by the findings of Cullen and Hickman (2001), Cullen, Hickman and Keast (2004), ECLOS (1999-2001) and LoTISS (2002-2005) is relevant to complex projects in the contemporary construction industry on the basis that endemic uncertainties occur over a long-term. It follows that the parties often are involved in close commercial (and frequently personal) relationships in order to resolve the unpredictable nature of contracting.

When there are conflicts between the parties on issues or contractual terms the consequent waste is manifested as unnecessary transaction costs. In expanding this theme, (Williamson 1973) contends that these initial transaction costs tend to escalate as the project develops (Cullen et al. 2004; Cullen 2005).

In Brownsword's (2000) analysis of business contracting, he proposed that the effect of overly prescriptive contract clauses tends to sub-divide processes into distinct and separate fields of operation. He reasons that as each party focuses solely on its own objectives and priorities that encourage strains in the parties' relationship to the detriment of the parties' rewards from the venture.

In this vein, Williamson's (1996) economic analysis of long term projects indicates that when parties work together on successive complex projects that investment costs are recoverable because they are embedded across other projects that share common elements. In this vein, complex construction projects can involve extensive pre and post

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contract investment in investigations, research and development. These outlays were found to be typical by Lichtig (2005) and supported by LoTISS (2002-2005) requirements for bidders to contract for sophisticated projects, support services and public-private partnership programmes.

Table 1: How Relational Norms Affect Construction Contracting (Based on Macneil, 1974 and 1978)

NORMS	CONSTRUCTION EXAMPLES
Relational: For their mutual benefit parties: Work together on the basis of flexibility and reciprocity in their mutual benefit. Remain separate economic units, whilst collaborating	Risk and revenue share contracts, possibly incorporating asset management Formalised requirements during the development phase to post contract award Main contractor embedded within the client organisation, acting as Construction Manager for the client, undertaking serial construction projects within the context of a framework agreement
Common: The parties have a united approach to: ▪ Preserving their relationship as they predict that they will work together in the future ▪ Harmonious dispute dissolution rather than conflicts ▪ Changes in the external environment	Contractors collaborate on contracts whilst also competing on others Conflicts resolved internally; rarely do the parties resort to litigation, adjudication or arbitration Main contractors retain the services of preferred sub-contractors on serial or successive construction projects
Discrete: The parties freedom to contract is limited in their mutual interests by: ▪ Restricting their individual freedom to choose how to execute the contract ▪ Accepting that they must take the consequences of focusing on the outcome of the contract, which restricts the individual party's freedom to act in its immediate interests	Suspension of strict legal rights during performance, to focus on a successfully completed contract for the benefit of all the parties Mutually beneficial conclusion to the project Use of ADR; informal third party dispute resolution clearly expressed in the written agreement (e.g. private), internal project forum, adjudication, arbitration)

From the theory of relational contracting that was founded by Macaulay (1963) and Macneil (1973 and 1978), a more recent management perspective has evolved from the works of Halson (1991), Lamming et al. (2001), Larsen and Bagchi (2002) and Diathesopoulos (2010). The common thread in these lines of research is the recognition of efficiency being increased through the adoption of relational norms. Examples of these traits include jointly developed, flexible and responsive working relationships between members of the main contract and their networks of subcontractors. These collaborative initiatives involve jointly developed improvements in work practices between organisations; for instance, these may evolve through quality circles, team working and integrated project teams.

It is worth noting that complicated layers of administration and monitoring both represent transaction costs that detract from the potential rewards for the parties. In this

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vein, Handy (1995) has consistently suggested that as monitoring is more costly than trust, and a balance between the two extremes should be sought by the parties

Relational Contracting or Legal Formalism?

In contrast to the relational contracting schools, a body of research supports the case for formalism in contract law[13]. The classical approach to contract law, combined with a strict approach to interpreting contract terms is supported by Scott (2000), who contends that if fairness and reasonableness are accepted as being legal doctrines, the outcome will be increased uncertainty for the business community. The basis for Scott's proposition is that precise and certain drafting of contract terms, renders the parties less likely to have misunderstandings and hence resort to litigation. He contends that in the commercial contracting context, concepts such as good faith cannot be specified with the clarity that is required by the law of contract.

This line of reasoning is acknowledged by Kreitner (2004), who proposes an objective theory of contracts. According to Kreitner, formalism increases the predictive basis of contract law in the context of how terms are interpreted. The basis of his proposition is that voluntarism has evolved as the heart of contract law. He proposes that this tradition of voluntarism (Pratt, 2007) should continue to underpin the Common Law of contract.

Although there are advantages for contractors to derive from a Kreitner's support for voluntarism and freedom to contract (McKendrick, 2003), these concepts tend to benefit the stronger party, who can take the opportunity to impose its authority over the weaker one. Although the objective of laissez-faire contracting is to allow commercial parties to maximise the efficiency gains that are potentially available from the transaction, it also serves to preserve the status quo ante in favor of the party that initially holds the balance of power.

Interestingly, despite his support for legal formalism, Kreitner also recognises a relational element as existing between commercial parties. In this vein, he concurs with Macneil (1978) in his recognition of the social context of contract law, in his suggestion that it operates in conjunction with voluntarism to provide an infrastructure that encourages cooperative working relations.

In common with relational contracting norms, transparency in working practices requires that the terms in the formal documents recognise that the parties will simultaneously apportion risks and develop mutually attractive incentives that essentially involve:

- Equitably identifying risks and rewards that have been apportioned between the negotiation to formal agreement phases
- Clarity in monitoring operations, accountability and obligations
- Agreeing common incentives
- Developing rewards that reduce opportunism and self-interest

13 C.f. Campbell I D and Picciotto S (1998) "Exploring the interaction between law and economics: the limits of formalism~" Legal Studies, Journal of the Society of Public Teachers in Law, Vol.18, Sept, 249-278

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Currently, there is a discernible use of more relational contract forms[14]; UK and USA exemplars of contracts that have been broadly classified as being relationally grounded include:

- Engineering and Construction Contract (2009)[15]
- JCT Construction Excellence Contract (2009)[16]
- Hanson Bridgett LLP Integrated Project Delivery Agreement (2009)
- Project Alliance Agreement (2007)
- Integrated Agreement for Lean Project Delivery (2009)
- Consensus DOCS3000

Cullen et al. (2004 and 2005) found that the common thread in all these construction contracts is the express recognition that the parties can maximise their common benefits by collaborating during the term of the project, rather than competing against each other to merely realise short term gains. In this context innovative management structures are implemented to underpin the long-term, holistic basis of relational contracting[17].

From this basis of reciprocity the parties also recognise that they must embody their relationship in a legally binding contract.

Conclusions and Recommendations

The objective of this paper was to examine the theoretical background on relational contracting with regard to the Common Law principles of contract. These relational and legal aspects were analysed in the context of the use of contract forms in support of the application of relational contracting in construction.

Accordingly, a brief over-view of the concepts was proposed on to scope the issues that surround initiatives to promote a relational contract in order to effectively manage a construction project.

The adaption of the relational contracting theory in contemporary practice in the construction engenders good faith and a holistic perspective of the final outcome of the project. The normative elements that seem to be predominant in construction forms of contract that are relationally grounded may be summarised under the following classifications:

- Working together in cooperation for the duration of the project
- Developing and complying with rules of procedure, with a project focussed management structure and clear lines of communication, roles and duties
- Joint identification allocation of risks to those parties who are most able to manage them
- Incentives that focus on the project as a whole to discourage opportunism and short term self interest
- Performance indicators

14 q.v. Hanson Bridgett (2010) Comparison of Integrated Project Delivery Agreements, California
15 EEC is based on the New Engineering Contract (NEC)
16 JCT - Constructing Excellence Contract Guide, Revision 2009 (originally the Building Excellence or "BE" form of contract
17 Passim: Contract provides for the main suppliers to form a limited life consortium company for the duration of the project, (as in Swatch and Mercedes to develop the Smart car). The LLC is a single corporation that contracts with the client; any non members of the LLC deal with the LLC not its members.

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- Transparency
- Internal dispute resolution and proactive dispute avoidance
- Importing the "overriding principles" of the project into specific roles

In essence, the cumulative propositions of the relational contracting school of thought concurs that it is advisable for contracting parties to *express both* their technically grounded obligations and relational practices in detailed agreements. Indeed, the cases of *Williams v Roffey*, *Walford v Miles* and *Baird v M & S* send notes of caution that relational norms must be *expressed* with *certainty*. This support for expressly drafting relational contracting terms concurs with contract being a legally binding agreement between two or more parties, with an intention to create legal relations that are certain and not obtained under conditions of economic duress.

Therefore, it is proposed that future research compares contract forms and organisational alliances that support relational projects in contrast to traditional, transactional forms. These objectives would be achieved by evaluating how the parties to complex, long-term construction projects intend to work together with their *actual* working relations. The practical and academic outcomes of this research would consider the nature and roles of both trust and incentives as "relational glue" that provides the parties with the potential to derive mutually attractive rewards.

Acknowledgments

The authors would like to thank the organisations that kindly permitted the release of their relationally grounded forms of contract. These documents were a valuable source of information for this paper.

All errors and omissions are the responsibility of the authors.

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