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## Defining the Relational Charter for Commercial Project Contracts

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### Abstract

Contracting is an integral part of project management. The contract stipulates the legal and commercial relationship between the two engaging parties. The dynamics of this mutual, contractual agreement is contextualized in the principle-agent theory. In practice, the effectiveness of executing the contractual agreement is dependent on relationship management between the principal and agent, which does not necessarily form part of the formal agreement. This paper aims to identify variables that define the principle-agent relationship and formulization of that in a relational charter. A conceptual model is developed to assess the validity of the agency and relational variables and their interrelationship towards the formation of a relational charter. This paper provides insight into the literature review and conceptual model to be used in field research.

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### 1. Introduction

This research presupposes that, in addition to traditional contracting, a relational agreement can influence the behavior of contracting parties. It is believed that the traditional form of contract increases the probability of unnecessary project disputes, losses, and possible failure [1]. Risk averseness and ‘arm’s length’ nature of traditional commercial contracts can often lead to frustration and tensions, encouraging opportunism and adversarial behaviors

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[2]. Adversarial behavior can increase the possibility that the contracting parties will not share all project-related information [3]. In recent years, contracts have been modified to adopt some relational norms to reduce the impact of the agency problem. These norms are universally applicable and relevant to the individual project requirements but depend largely on the contracting parties' chosen procurement strategy and delivery method. Owing to this lack of available forms of relational contract, a range of literature identified fundamental relational tenets and norms central to contractual relationships. These tenets and norms have been shown to positively impact the contract's effectiveness and the relationship, as they guide the behavior of individuals and organizations, reduce project-related risks, increase information-sharing and goal congruence, and ultimately improve project outcomes [4]. A form of relational charter intends to improve the contractual relationship between the contracting parties [2] and may be added as an annexure to a traditional contract. The relational charter is not a new concept and is a secondary Option (Option X12) in the New Engineering Contract (NEC3), referred to as 'Partnering' on integrated project delivery [5]. Project "Partnering" agreements have gradually become a non-adversarial and performance-enhancing approach to contracting in various international markets, with the relational aspects being less prominent. Irrespective of the form of contract used, research and practice have shown that the agency problem is ever-present [6]. The principal-agent relationship is ultimately influenced by agency variables such as the separation of ownership, goal incongruence, information asymmetry, the difference in risk preference, and moral hazards [7]. Traditional commercial contracting methods have been criticized for being inequitable, adversarial, and inefficient due to their focus on price and power, resulting in contractual issues. Relational contracting is intended to improve project process efficiency by strengthening the relationships between project stakeholders [8].

### *1.1. Research problem*

Initial investigations reveal that existing literature does not specify nor analyze the agency or relational variables that influence the principal-agent relationship in commercial project contracts.

### *1.2. Research questions*

Given the research problem statement, the associated research questions are as follows:

- Which variables define the principal-agent relationship?
- Can agency and relational variables define the relational charter in commercial contracts?
- Can the relational charter affect the principal-agent relationship positively during the execution of a project?

## **2. Literature Review**

### *2.1. The Agency Problem*

The agency theory is concerned with resolving two problems in the principal-agent relationship [9]. The first problem is the agency problem, which occurs because of conflict that arises from a divergence between the principal's and the agent's goals, desires, and behavior. The second problem is risk-sharing, which occurs when the principal and the agent have different risk appetites [10]. This type of relationship is known as the 'principal-agent relationship'. There are several reasons for the occurrence of the agency problem, such as the separation of ownership from control, conflicts of interest, self-interest, opportunistic behavior, different risk attitudes, length of involvement in the contract, unsatisfactory incentive plans, limited earnings, information asymmetry, goal congruence, and moral hazards [11] and [12]. The agency problem can be divided into two further sub-sections: (a) The result of conflicting goals between the principal and the agent and (b) the expected behavior of both parties [9] and [13].

Separation of ownership occurs when the principal assigns a task to the agent, hoping the agent will work for the principal's benefit. However, the agent might be more interested in maximizing their compensation. Thus, the separation of ownership from control increases the conflict of interest and the cost of the agency [11]. The principal's position within the relationship will directly affect the agency relationship. To reduce the impact of the separation of ownership and the cost of the agency, the principal proposes to be directly involved in monitoring [14] and [15]. As

the agency conflict between the principal and agent increases, the agency cost will rise [11] and [16]. Agency conflict can be divided into relational and task conflict that negatively affect team performance, team member satisfaction, trust, and expectations of future cooperation [16] and [17]. According to agency theory, conflict can be reduced by using suitable corporate governance mechanisms such as outcome-based contracts, information systems, monitoring, and trust [9] and [17]. Outcome-based contracts can measure performance metrics with the agent's compensation linked to the principal's goals and objectives [11]. Information systems potentially curb the agent's opportunism, as the principal will be aware of the agent's actions. Therefore, the agent will realize that their actions and behavior are being monitored and will likely be unable to deceive the principal. However, close monitoring of the agent's performance can lead to distrust, induce opportunism, influence cooperation, and produce defensive behavior [18] and [19]. Various studies have found that higher levels of trust can reduce this effect and thus reduce transactional costs [18] and [20]. The agency theory further suggests that the principal and the agent will maximize their self-interest, even if it is not in the interests of the other party [9]. Self-interest is typically managed by opportunity control, incentive control, and benevolence (or goodwill). When the actions of both parties in the agency relationship are difficult to observe, it can lead to opportunistic behavior, a typical example of which is when the principal awards the contract to the lowest bidder. This decision could lead to the agent exposing the principal to post-contract claims and price overruns, thus monopolizing the commercial position [21]. A formal contract is likely to reduce opportunistic behavior and improve contractual performance, but it is recommended to do this through a relational exchange [3] and [22]. Opportunistic behavior violates relational norms, which might not be stated explicitly in the agreement, but forms part of the common understanding between contracting parties [23]. Information asymmetry suggests that one party is better informed about the other's capabilities and actions [13]. According to the agency problem, information asymmetry is defined by three concealed sources of behavior in the relationship between the principal and the agent [24]. These are hidden information, hidden characteristics, and hidden intentions, which respectively generate the following behavioral risks: adverse selection, moral hazards, and hold-ups [24]. Information asymmetry at the early stage of the agency relationship leads to an adverse selection problem, and at the later stages, it leads to the moral hazard problem [25] and [26]. The literature agrees that consensus about the project's goals is a precondition for its success [4] and [27]. If there is no goal alignment, this will result in a maladaptation of the process, product, and purpose [28]. Goal congruence can be achieved through contractual norms such as team chemistry, role integrity (performing with the project's best interests in mind), aligning organizational goals with project goals, contractual solidarity, adapting to changing conditions, reciprocity, restraint of power, and harmonizing of conflict [29]. Fair risk-sharing and allocation of responsibilities contribute to collaboration [30]. With a lack of trust between the principal and the agent, both parties appear risk-averse and vigilant, with a low willingness to share risks [30] and [31].

## 2.2. Relational Norms

In society, certain social norms exist that have extensively been studied in the social sciences. These informal rules or shared expectations govern the behavior of people, groups, organizations, and societies. Generally, violation of the social norms generates risk as the opposing party will create strategies to protect themselves and to improve their position in the form of opportunistic behavior. Macneil arrived at a set of ten common contractual norms by studying the relationship as the unit of analysis while focusing on the behaviors. Thus, all contracts variably apply these ten expected behaviors, whether transactional or relational. Thus, contracts vary from transactional at the one end of the spectrum to relational on the other end. Without these norms contracting parties would face difficulties interacting [33] and [34]. The common contractual norms are role integrity, contractual solidarity, effectuation of consent, creation and restraint of power, the propriety of means, reciprocity, role integrity, flexibility, harmonization, implementation of planning, and cohesive norms [33] and [34]. The ten common contractual norms can be combined into six social norms: reciprocity, autonomy, honesty, loyalty, equity, and integrity [2]. This is not an exhaustive list, and thus, contracting parties should add relevant social norms if required, like Ludwig Wittgenstein's core and non-core elements [2] and [4]. Given the above variables, the establishment of a sustainable, mutually beneficial relationship is not an automatic occurrence once a commercial project contract is signed. The relational complexity must be acknowledged, and once addressed in a transparent format, a more formal or mutually accepted relational charter can be agreed.

### 2.3. Relational Charter

The proposed relational charter is not intended to replace the traditional contract but to embed social norms in the developing relationship [32]. The relational charter is not intended for parties to discuss how to resolve issues beforehand but rather to agree on the collaborative procedures to resolve any that arise. Therefore, the proposed relational charter is not like the ‘Partnering’ charter, which only signifies the agreement of the contracting parties to commit to the project objectives and does not consider or mention the relational tenets, norms, or elements identified [2]. Ideally, the charter should be developed before the contract is signed to avoid the contract price and power being used to manage the contractual relationship. It is never too late to implement a relational charter [2].

### 3. Conceptual Model

The literature on the agency problem has shown this to be a complex construct. No theoretical model is available to illustrate the agency variables according to the agency problem. Therefore, a comprehensive literature review found common themes that describe or impact the agency problem, as shown in Figure 2. and forms the conceptual model of this research in Figure 1. Key variables were identified that impact the principle-agent relationship with respect to the agency problem. These variables are but not limited to separation of ownership, agency conflict, self-interest, opportunistic behavior, information asymmetry, goal alignment, risk sharing, and agency cost. Agency variables such as agency cost and risk transfer were the most common identified themes in the literature review defining the agency problem. The latter supports the common issue with traditional contracting is that it is formulated on two foundations – price and power. The other identified agency variable themes such as separation of ownership, agency conflict, self-interest, opportunistic behavior, information asymmetry, and goal alignment were almost equally mentioned. Trust was also identified but is beyond this research and was not included as an agency variable.

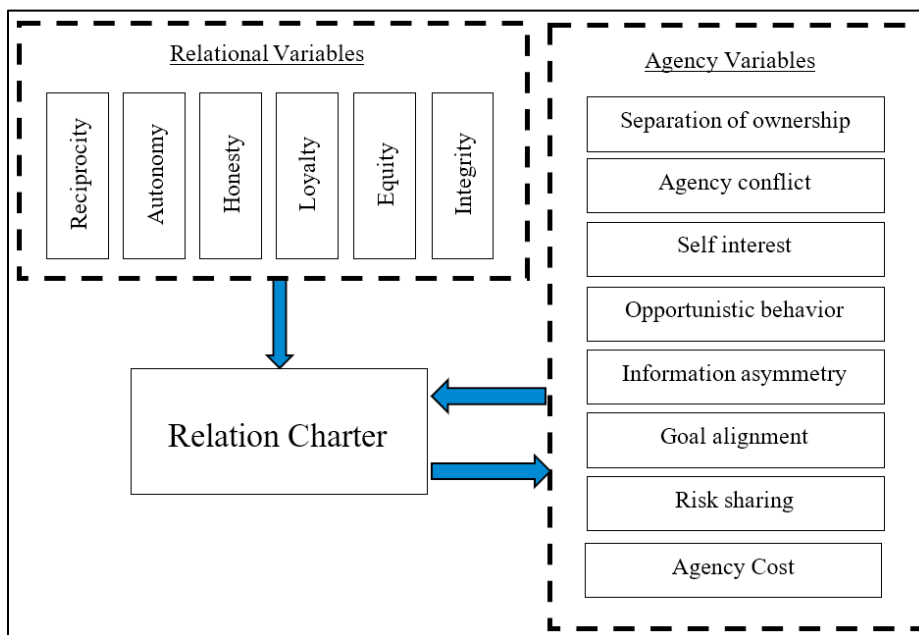


Fig. 1 Conceptual Model

To further illustrate the relational dynamics, a concept relational flow diagram was constructed in figure 2.

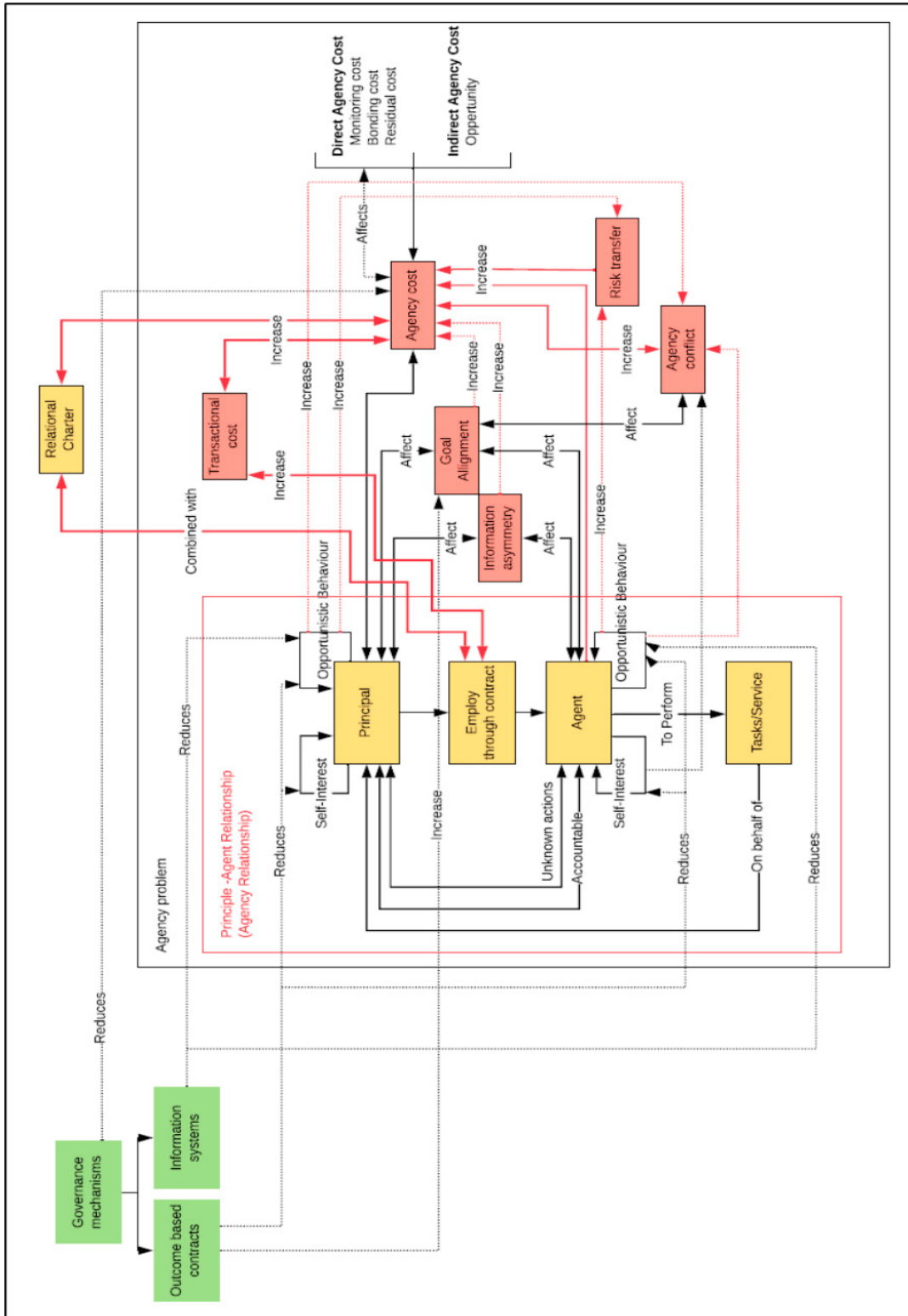


Fig. 2 Relational Charter Dynamics

#### 4. Proposed Field Research Methodology

A cross-sectional study using a mono-quantitative approach is proposed. Inferential surveys will be used to establish the relationship between the principal-agent (dependent) and the relational charter (independent) variables. A self-completing questionnaire with a 5-point Likert scale will be distributed to a sample of various project teams. The unit of analysis for this research is the contractual relationship between the principal and the agent on various projects. The primary data collected through the web-based questionnaire survey will be analyzed using the Statistical Package for the Social Sciences (IBM SPSS Statistics). The research will apply descriptive statistics, including correlation and multiple regression analysis.

#### 5. Conclusion and Expected Results

So far, a draft of the relational charter dynamics was composed using the literature, as well as a conceptual model. The conceptual model suggests that the agency variables are a function of the agency problem, drawing from agency theory, the agency problem, the principal-agent framework, and transaction cost theory. The following variables were identified as key agency variables that have been repeatedly discussed and identified by various researchers: separation of ownership, agency conflict, self-interest, opportunistic behaviour, information asymmetry, goal alignment, risk sharing, and agency cost. There was evidence that agency variables can define the agency relationship, thus confirming research question 1.

The literature review provided evidence to identify which norms can define the relational charter. Research conducted in sociology, game theory, economics, and other social sciences showed that relationships built on trust and various social norms outperform traditional relationships. It was concluded that six guiding principles are the foundational social norms for an effective relationship and that these six key social norms build trust when creating a collaborative relationship. The six identified guiding principles were reciprocity, autonomy, honesty, loyalty, equity, and integrity. This is not an exhaustive list, and contracting parties can add whatever social norm is applicable. However, it has been found that these social norms form the basis of most other social norms. There was evidence that relational variables can define the relational charter in commercial contracts, thus confirming research question 2.

At the end of this work, it is expected to determine the correlation between the agency and the relational variables and investigate the relational charter's impact on commercial project contracts. In addition, this work aims to contribute to the body of knowledge by elaborating on the concept of the relational charter and relational contracting as applied to commercial projects and to add a link between the integration of the relational charter and the principal-agent relationship.

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