



## **Doing Business in China: What is the Use of Having a Contract? The Rule of Law and Guanxi when Doing Business in China**

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### **Abstract**

*Contracts in China do not appear to have the same binding effect as it does in the Western world. For example in China, when the economic situation underlying a contract changes, the Chinese party expects the terms of the contracts to be renegotiated. Furthermore, because of weak courts, enforcement of contractual terms is uncertain (Yao and Yueh, 2009). So, what is the use of having a contract in the first place? Is there no rule of law in China? This article sets out the proposition that there is rule of law in China. However, contracts and the laws in China must be interpreted from the Chinese perspective. That perspective is that relationship (otherwise known as “guanxi”) is paramount to the terms and conditions of contracts. Contracts merely formalize a relationship that presumptively is based on mutual respect and trust. So if the situation changes, contract terms should be modified out of mutual respect and trust for each other (Ambler, Witzel, and Xi, 2008). Furthermore, this article argues that guanxi is being institutionalized by way of concepts written into the laws of China and the manner in which the courts of China interpret those laws, so that guanxi must be understood in order to successfully do business in China. Nonetheless, it is recognized that as China becomes a global player in the world markets, she will be forced to adhere to generally accepted international standards for commercial dealings. This may cause an erosion of the role of guanxi in the application of law, but we believe guanxi will remain at the core of business practices in China.*

**Key Words:** China, guanxi, everyday guanxi, special relationship guanxi, rule of law, doing business in China, China’s Contract Law.

## Introduction

In March 2010, Australian citizen Stern Hu and three of his Chinese colleagues were sentenced to lengthy prison terms for bribery and stealing commercial secrets. Mr. Hu and his colleagues were executives of Australian iron ore mining company Rio Tinto. They were convicted of taking kickbacks from steelmakers to arrange preferential access to iron ore. The charges for stealing commercial secrets were not clearly stated in the lawsuit (Restall, 2010).

In the early 2000s, China's steel industry significantly expanded capacity. As demand for iron ore soared, so did market prices. Rio Tinto began to back out of its contracts claiming "force majeure". Contracts were renegotiated at 87% higher prices. When the demand for iron ore weakened during the economic crisis at the end of 2008, the Chinese buyers walked out of contracts with Rio Tinto. But then, demand for iron ore rose again by the middle of 2009 as the result of Beijing's fiscal stimulus program. Rio Tinto took this opportunity to demand higher prices again. Given this hostile relationship, reportedly someone from the Chinese buyers' side alerted the Chinese authorities to investigate Rio Tinto for wrongdoing. The investigation culminated in Mr. Hu and his colleagues being arrested on July 5, 2009 (Restall, 2010). Looking back at the events that led up to the convictions, arguably, the principal reason the Rio Tinto executives were imprisoned is that trust broke down as a result of the failure to establish strong guanxi relationships of mutual respect.

So, is there any rule of law in China? Do contracts mean anything? Are contracts merely an agenda symbolizing progress, but nothing more, since it is merely proof that both sides have grown close enough to want to develop a trusting business relationship (Ambler, Witzel and Xi, 2008). Some foreign executives who do business in China are of the opinion that what matters most are relationships; contracts carry very little weight (Farh, Tsui, Xin, and Cheng, 1998; Standifird and Marshall, 2000). In this article we pose the following questions:

*Research Questions: What is the usefulness of contracts in doing business in China? Are the contractual terms actually binding on the parties? Are contracting parties expected to adhere strictly to the terms of the contract, or to renegotiate terms when underlying fundamental events change?*

We theorize that the usefulness of contracts depends on understanding its importance from the Chinese perspective – which is that contracts are vehicles for establishing a guanxi-type relationship of mutual trust and respect. To the Chinese, guanxi is a personal connection to which the parties are bounded by an implicit psychological contract to maintain a long term relationship, mutual commitment, loyalty, and obligation beyond the bounds of a written contract (Chen and Chen, 2004). Nonetheless, as subsequently proposed in this article, there are boundaries as to what is acceptable and not acceptable when it comes to implementation and enforcement of that psychological contract.

This article starts by summarizing the foundations of guanxi handed down from generation to generation in order to illuminate the Chinese perspective of laws and contracts. We then argue that guanxi is not incompatible with the rule of law, and in fact is supported by the general principles of the law of contracts. The question remains as to how guanxi may change as China continues to modernize and globalize. This is left for further research, but our article provides a theoretical framework for future analysis and expansion:

*Theoretical Framework Proposed: From the Chinese perspective, contracts are useful for establishing the terms for a long lasting relationship. The Western definition of rule of law is that such contractual terms must be strictly followed; whereas, the Chinese give more importance to guanxi (relationships) so that in their minds the definition of the rule of law means preserving mutual respect and trust by being willing to renegotiate contractual terms in the event of changes in the fundamental underlying basis for the contract. So, there is rule of law in China; it is just a matter of definition.*

## 2. Literature Review

### Contracts from the Chinese perspective

China has promulgated thousands of laws, especially as she opens up to the world as a major player in the global market. It became a priority for China to firmly establish its commitment to the rule of law. The Chinese rulers did so in 1999 by amending their constitution to enshrine that principle (Orts, 2001). So, there is rule of law in China, but in practice how is it being implemented and interpreted? To understand how the Chinese view laws as they related to contracts, one must look back at China’s several thousand years of history and tradition. Notably, Confucian teachings have a strong influence on Chinese thinking. Guanxi is a Confucian heritage passed on from generation to generation, and remains in the soul of the Chinese (Chen and Chen, 2004). Confucius emphasizes moral standards over formal law (Zhang, 2006). Such moral standards include mutual trust and respect cultivated through strong relationships (otherwise called “guanxi”). Buddhism also influences the approach of the Chinese to law and contracts. Buddhism emphasizes social harmony and frowns on direct confrontation (Pan, Rowney, and Peterson, 2012). Therefore, for example, the Chinese tend to avoid disagreeing directly. To the Chinese, maintaining relations is a deeply embedded social value and paramount to the law. A contract is merely a formality, and entered into without much consideration to legal enforcement (Leonhard, 2009). In contrast, Westerners are more direct and approach dealings in linear logic fashion with clear alternatives – if option A is not acceptable, then go to option B, etc. The Chinese, on the other hand, in order to establish a solid basis for a strong relationship going forward, may examine ways to combine option A and option B, or take different parts of each option (Ambler, Witzel, and Xi, 2008). The following chart shows the differences in approaches:

**Table 1:** Differences Between Chinese and Western Culture (Chen and Partington, 2004; Hempel, 2001):

<b>Chinese Culture</b>	<b>Western Culture</b>
Group orientation	Individual orientation
Relationship driven	Goal driven
Conflict averse	Inclined to address points of conflict
Seeks harmony, avoids confrontation	Seeks immediate resolution of issues

Communication is top down	Communication is multi-directional
“No” terminates negotiations	“No” means “make me another offer”
“Yes” enables negotiations to continue	“Yes” is an agreement to close the deal

But aside from philosophy, there also were practical reasons for relying on relationships. When China was still an agricultural society, laws were fewer and there were lack of institutions for effective enforcement of whatever laws there were. Consequently, people had to rely on guanxi rather than on laws to do business. People dealt with family and friends based on the assumption they will be around the same community long enough to reciprocate favors (Ambler, Witzel, and Chao, 2008). During recent Chinese history, the Cultural Revolution, again guanxi became important as the only way to get things done through difficult times (Gold, 1985). As capitalism came to China, it continued to be practiced under the principle of guanxi that was based on the assumption that the parties will be reachable; otherwise the social capital created by reciprocal favors will not be of any value (Gold, Guthrie, and Wank, 2002). While the West was more transaction-oriented in their business dealings, the Chinese remained more relationship-oriented. Americans want to sign up the deal or project first, and then develop relationships afterwards. The Chinese want to deal with people they know, like and respect first, then do the transaction or project. If anything goes wrong, the Chinese expected that the counterparty would be contactable and would deal with problems in such a manner as to maintain a long-term relationship (Gold, Guthrie, and Wank, 2002). That relationship must be based on mutual respect, realism and flexibility that evolve over time. If the situation changes to the detriment of any party, then the parties must discuss it and be prepared to modify the terms of the deal. The Chinese want a partnership relationship mutually advantageous to all parties (Gold, Guthrie, and Wank, 2002). Therefore, the Chinese establish a trusting relationship first, and then business transactions. Westerners negotiate transactions first, and then wait for relationships to follow (Gold, Guthrie, and Wank, 2002).

So, does that mean there is no rule of law, since legal contracts can be supplanted under the guise of the importance of guanxi? Although guanxi and “face” (which equates to respect) are at the core of doing business in China (Park and Luo, 2001), it is not alien to what is done in other parts of the world. Actually, it is similar to what is practiced in other countries in Asia, Africa, South America, and even in the capitalist West. No matter where you are, business relationships that do well and last are those that are based on mutual trust and face, which means, among other things, the willingness to accommodate unforeseen difficulties encountered by your counterparty (Park and Luo, 2001). Depending on how guanxi is defined and how it is practiced, guanxi can be compatible with capitalism and can coexist with the rule of law (Scott, 2008).

### 3. Theory Building

#### **What is acceptable guanxi, and what do the Chinese expect in their relationship with foreign partners?**

There is a difference between “everyday guanxi” and “special relationships”. Generally, everyday guanxi is where the parties exchange gifts of appreciation in order to expedite or secure the performance of routine corporate or government actions – this is somewhat like “grease payments” or social capital investments. With everyday guanxi, the Chinese party knows what

will be acceptable and what may not be acceptable, but all within the standard operating procedures and corporate policies. Special relationships *guanxi* is what gets you in trouble because this often involves bribes to get things done through a close relative or an official or executive or a customer or supplier to obtain approvals of deals outside of standard operating procedures (Luo, 1997). Because *guanxi* easily can blur the line between legitimate business dealings and corruption, one needs to be careful as to what type of *guanxi* is being used. Remember that China does have laws, and the Chinese have high regard for bureaucracy, procedures and regulations (Luo, 1997). The use of *guanxi* to expedite matters within standard operating procedures is acceptable and can co-exist with the rule of law, being no different than hiring consultants who have knowledge and experience in handling matters.

The *guanxi* (relationship) starts with the parties identifying and creating a *guanxi* base through familiarization and then establishing a commonality of values and goals (Chen and Chen, 2004). It is not enough to just show the Chinese party your business plan and how profitable a venture with you can be. They want to know you as an individual. Are you a person they can trust? Will there be mutual respect for the views of each party? Trust and mutual respect means you must be willing to compromise. They do not separate business life from personal life. So, you need to go out to dinner with them, have fun with them, etc. You must show you are willing to share information, involve them in product development, give them better terms, help them finance their raw materials, etc. The Chinese want you to be a real partner with them in terms of a long term commitment to working together for the benefit of all partners (Gold, Guthrie, and Wank, 2002). However, this does not mean you do not take care to protect your interest. Among other things, you still need to protect your intellectual property with appropriate clauses in the contract, and ensure that your interpretation of contractual duties and obligations are consistent with the understanding of your counterparty (Yu, 2005). It is just that when unforeseen events cause major difficulties for your counterparty, you exhibit trust and respect by your willingness to renegotiate suitable terms.

In the context of contracting, *Guanxi* means being real partners - exhibiting trust and respect and willingness to help each other in difficult times, even to the extent of willingness to renegotiate terms when unforeseen events occur. Everyday *guanxi* is positively associated with whether the contracting parties will adhere strictly to the terms of the contract, or be willing to renegotiate the contractual terms when underlying fundamental events change, both being acceptable actions within the Chinese definition of the rule of law. Therefore we propose the following:

*Proposition 1: When the underlying fundamental economic events change (1a) Guanxi is an antecedent to a Chinese contracting party's insistence on adhering to contract terms and (1b) guanxi is an antecedent to a Chinese contracting party's willingness to renegotiate the terms of a contract*

### **The obligations of *guanxi* should not be taken lightly**

One must be willing to exchange personal favors. But, beware of excesses that trap you. Small gifts are expected and appreciated; large ones can become bribery. Small gifts generally are taken as a show of appreciation and respect, whereas large gifts imply an obligation for the recipient to do something which may not be strictly in accordance with acceptable practices. Aside from size of the gifts being one distinction, another important distinction is that *guanxi* is for long term relationship whereas bribery is for short term benefits (Lovett, Simmons, and Kali, 1999).

Also note that there is a different standard for Westerners when it comes to acceptability of guanxi. Westerners are not only accountable to the laws of their own countries, but also Chinese regulators hold Westerners to a higher standard (Luo, 1997).

Guanxi results in real obligations that should not be taken lightly in terms of favors that must be reciprocated, but also in terms of what is appropriate within the bounds of legality in China and your home country.

*Proposition 2: Reciprocal gift giving is an antecedent to guanxi .*

### **Guanxi has been institutionalized into China's legal system and is supported by general principles of commercial law**

Westerners view contracts as a list of legally binding rights and obligations. Chinese see contracts only as a list of expected rights and obligations, depending on the situation (Buttery, 1998). Using the principle of mutual trust and respect underpinning guanxi, if the situation changes, there should be flexibility to change legally binding terms and conditions set out in contracts. Otherwise, each party remains bound by such terms and conditions of the contract.

This guanxi approach is supported by three principles of commercial contract law – fairness, good faith, and the safeguarding of public morality. These principles play a fundamental role in how contracts are performed and how disputes are resolved. Instead of strict compliance to the terms and conditions set out in contracts, the Chinese expect a fairness approach, thus renegotiation of contract terms to account for changing circumstances. Furthermore, if disputes arise, the Chinese party generally will insist on some form of renegotiation before beginning formal dispute-resolution proceedings (Graham and Lam, 2003). Renegotiating is akin to the parties agreeing to mediation, so is compatible with the rule of law. Mediation is a guanxi approach since it is in the tradition of Confucianism, meaning to find a mutually acceptable solution without any party losing face (Ge, 1996; Clarke, 1991).

Moving forward, China has institutionalized guanxi into its legal system. On March 15, 1999, at the Second Session of the Ninth National People's Congress, the new unified Contract Law of the People's Republic of China was adopted and came into force on October 1, 1999. The General Provisions of this new Contract Law were similar in spirit to those contained in Principles of International Commercial Contracts established by the International Institute for the Unification of Private Law (UNIDROIT), an intergovernmental organization consisting of 63 members including the United States and China. Articles 3 through 7 of the new Contract law set forth the basic principles of equality, fairness, good faith, and public interest. Although in different words, these principles are embodied in the UNIDROIT Principles (Yuqing and Danhan, 2000). Such principles can be said to be analogous to guanxi and, thus, incorporated into the rule of law as a generally accepted international principle under UNIDROIT. Given the institutionalization of guanxi into China's legal system the application of the rule of law in terms of the binding effect of contractual terms by contracting parties when doing business in China will continue to be affected by the guanxi way of thinking. Therefore we propose the following:

*Proposition 3: The principles of (3a) equality, (3b) fairness, (3c) good faith, and (3d) public interest will moderate the relationship between guanxi and contractual adherence and contractual renegotiation.*

## **Guanxi remains a strong social force in modern day China**

In the earlier days of China, being a highly centralized, bureaucratic state, guanxi became the counterpart of a commercial legal system (Ambler, Witzel, and Xi, 2008). Even as the commercial legal system developed, guanxi remained (Graham and Lam, 2003).

Ever since 1978 when China opened its doors to foreign direct investment, foreign investors and attorneys have contributed to legal reforms and the rule of law in China. Notwithstanding such legal reforms, foreigners also use guanxi to achieve their goals. The result was a “layering” or “bricolage” of guanxi to combine existing mature legal institutions with new legal forms introduced by foreigners (Scott, 2008).

Although the Chinese like to deal with family and friends, it was based on the assumption they will be around the same community long enough to reciprocate favors. During the past three decades of economic growth China has experienced one of the fastest demographic shifts the world has ever seen with the majority of China’s population moving from rural farming areas to urban areas. Therefore, it would seem that guanxi should become less important as more people move to cities (Ambler, Witzel, and Xi, 2008). But, even though guanxi may weaken due to population mobility, it still remains an important social force (Graham and Lam, 2003). The continuous development of a commercial legal system and population mobility in China is continuing to alter the social fabric of China, including guanxi relationships. Therefore, we propose the following:

*Proposition 4: The influence of guanxi on the contracting relationship will be moderated by 4(a) developments in the Chinese legal system, and 4(b) population mobility.*

## **Guanxi is an important part of a market economy**

In modern day China, guanxi maintains its importance as a social force through an institutional structure that reinforces its culture. Today, as an emerging rational legal system is constructed by China, business enterprises pay increasing attention to laws, rules and regulations. Arguably, this is because the Chinese government closely monitors large-scale commercial and industrial organizations. Furthermore, competitive market forces drive such organizations to focus on quality and service instead of relying on special relationships guanxi to gain a competitive advantage (Guthrie, 1998). But what about private entrepreneurs who are outside of the state coordinated forms of capitalism, including large and powerful state enterprises? Private-company executives continue to be more dependent on guanxi for protection than state-owned enterprises (Xin and Pearce, 1996). Guanxi is still needed to bridge the gap between the logics of their free-wheeling private capital accumulation and an economy controlled by the state (McNally, 2011). However, as China’s market economy and legal system continues to develop, the need for guanxi by private-company executives should fade in relevance in favor of competitive market forces as a rational and effective legal system is constructed in China. Competitive market forces that favor product quality and the establishment of good customer and supplier business relationships will change the guanxi contracting relationship. Therefore we propose the following:

*Proposition 5: In China, increased competitive market forces will moderate the relationship between guanxi and contracting*

#### 4. Discussion and Conclusions

Guanxi is fundamental to understanding how the Chinese view contracts and its performance. It is deeply rooted from thousand years of history and tradition, and is an integral part of Chinese culture. It has been handed down from generation to generation, either consciously or subconsciously, through the teachings of Confucius and Buddha, and remains in the sole of the Chinese people. Confucianism emphasizes moral standards over formal law, and Buddhism stresses social harmony and frown on confrontation. Consequently, it is more than merely developing a relationship. Guanxi requires mutual trust and respect. Given such a mindset, the Chinese definition of the rule of law in commercial dealings is the terms and conditions set out in contracts must be interpreted and applied in such a way as to preserve mutual trust and respect for maintaining a long term relationship. Contracts are situational base, not transaction based as is the approach of Westerners. If the situation changes, then based upon mutual respect and trust, the parties renegotiate the terms of the contract. According to Western paradigm, this would mean there is no rule of law. However, it is arguable whether or not Western legal concepts can or should be used to supplant deep rooted cultural values that underpin the China legal system (Leonhard, 2009).

Guanxi, or relationships, was essential for getting things done during the earlier days of China when the legal institutions were in their infancy. As China transitioned into becoming a major player in the global arena, she adopted new laws accordingly to conform to international standards of commercial dealings but, in doing so, incorporated guanxi into her legal system. The importance of guanxi remains in the psychic of the Chinese people. Consequently, there is the rule of law in China, but it is a matter of definition. One must interpret contracts in terms of its usefulness and the laws of China with guanxi in mind.

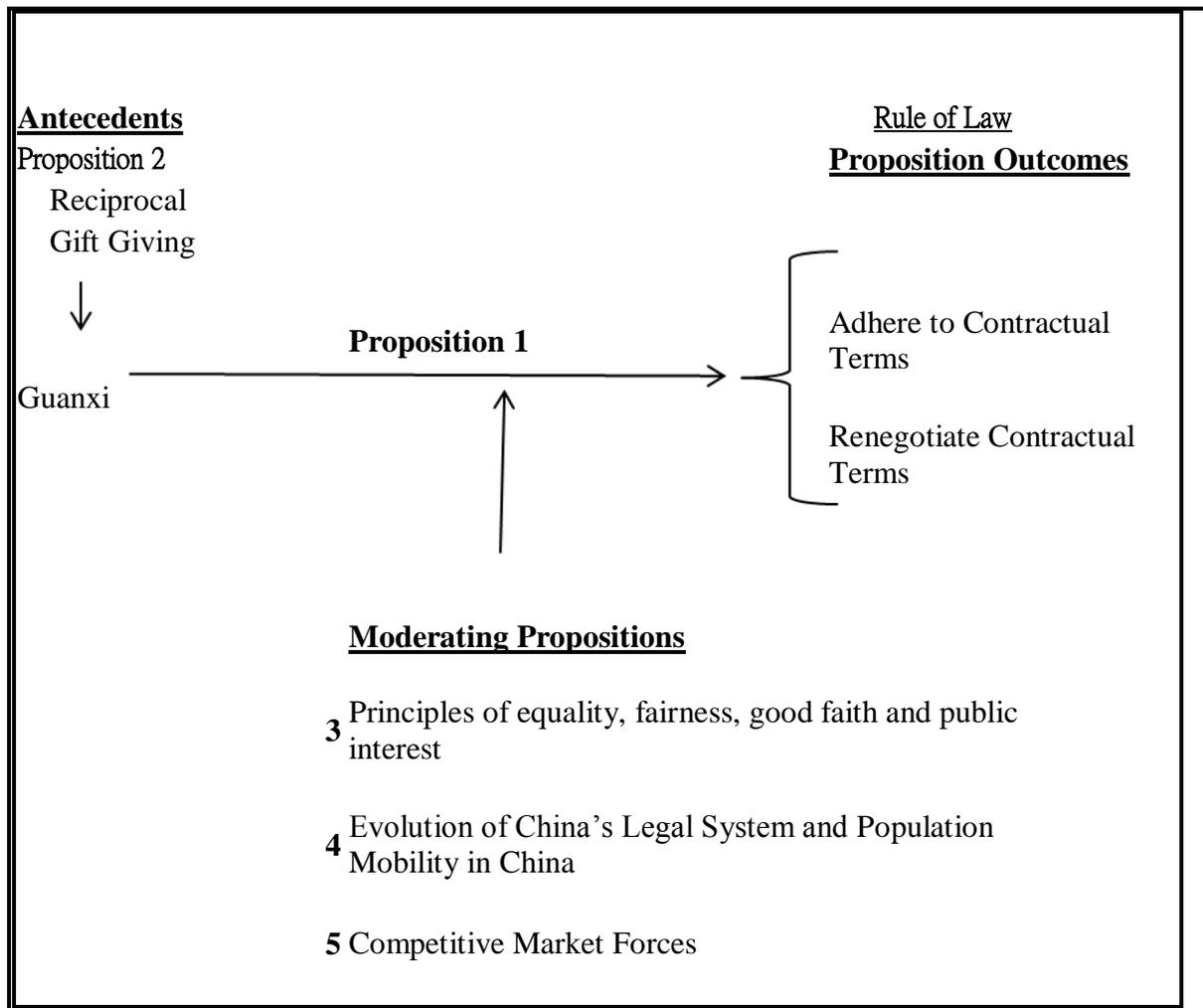
#### Contribution to Research

This article postulates that guanxi can co-exist with the rule of law and, in fact is being institutionalized into China's legal system. The usefulness of contracts depends on guanxi. Guanxi, which involves reciprocal giving of favors, can expedite procedures and help resolve contractual disputes to preserve long-term relationships for the mutual benefit of all parties – all within the rule of law as defined from the Chinese perspective. Guanxi is good business practice similar to what is actually being practiced in capitalistic economies. To have guanxi means establishing a psychological contract of mutual respect and trust, to be exhibited by the willingness to renegotiate contract terms if necessary to help the counterparty during difficult unforeseen times. This results in good business relations, which is essential for building competitiveness in a market economy.

We also argue that, notwithstanding the development of a commercial legal system in China, and population mobility that decreases the likelihood of reciprocal favors being honored; guanxi will remain an important social force through an institutional structure that reinforces it. However, the part of guanxi that uses social relations to take care of procedures in economic and political situations (special relationships guanxi) will fade.

From our study, we developed a theoretical framework, as demonstrated in **Figure 1** below, to assist researchers and practitioners to understand the Chinese perspective of contracts, and to provide a foundation for further research to validate the propositions upon which our arguments are based.

**Figure 1: Conceptual Diagram of Propositions**



Contracts in China are useful and needed to set out the terms and conditions of the parties and their working relationship. But, as illustrated in **Figure 1**, the rule of law that applies to the formation and implementation of those contracts is affected by *guanxi* – depending on the strength of the *guanxi*, when the fundamental basis for the contract changes dramatically, the contracting parties would either strictly adhere to the contract or would be willing to renegotiate contractual terms. If the *guanxi* is strong, in order to preserve respect and trust through reciprocity so as to foster a long term relationship, the contracting parties would be willing to renegotiate when confronted with unforeseen difficulties. The building of social capital through the reciprocal giving of gifts (which can be tangible or intangible in terms of favors) is important for strengthening of *guanxi*. However, *guanxi* itself also is being moderated by the development of China's legal system which, on the one hand is institutionalizing *guanxi* into its system while, on the other hand is reducing dependence on relationships. Furthermore, competitive market forces that favor product quality and good customer and supplier relationships (as opposed to special personal relationships) is moderating *guanxi*.

## **Our theoretical framework as a basis for future analysis and expansion**

Our theory is that, from the Chinese perspective, contracts are useful for establishing the terms for a long lasting relationship. The Western definition of rule of law is that such contractual terms must be strictly followed; whereas, the Chinese give more importance to guanxi (relationships) so that in their minds the definition of the rule of law means preserving mutual respect and trust by being willing to renegotiate contractual terms in the event of changes in the fundamental underlying basis for the contract. So, there is rule of law in China; it is just a matter of definition.

Obviously, our theory is not all inclusive and other antecedents and moderators of guanxi and of the rule of law will need to be considered. Nonetheless, hopefully, our theoretical model will at least provide a useful framework for further research. For that further research, you may wish to consider the following possibilities.

Given the proposition that guanxi is being institutionalized and layered into the formal legal system of China, more research needs to be done on how this works in practice. One must recognize that China is a huge country where interpretation and enforcement of laws are not yet uniform. Consequently, the need for relationships to get things done becomes the counterpart of a commercial legal system, and this can vary from region to region. It also can vary from industry to industry, since some industries are more regulated and protected than others. There are many other situations where the importance of relationships can vary; for example, relationships are more important for private entrepreneurs; and relationships will not be as important where the dealings are on a short-term one-off basis.

There also are variations caused by time, so that the propositions presented by this research must be constantly updated to see where they may lead. One possible view is that, as international conventions imposed by such organizations such as the World Trade Organization are imposed on China as the price to pay for being part of the global community, despite deep rooted cultural values, guanxi eventually will be eroded and even eliminated by Western style rule of law. On the other hand, some commentators believe that the survival of guanxi is not so much an economic issue as a practical dependency issue. Guanxi networks are like clubs that guarantee its members the enforcement of their rights - more cost efficient than legal systems that require lawyers, time spent in courts, etc. However, in the longer term, when club members become too many in number to be effective and as enforcement through China's legal system improves, the legal system may become a better alternative to the guanxi network (Schramm and Taube, 2003).

Another interesting theory is that both the Western rule of law and the Chinese guanxi approaches are defective since their underlying economic systems are based on an incomplete model of trust. Lack of trust decreases market efficiency and increases transaction costs. Therefore, instead of the guanxi model being replaced by the Western model, both models will eventually converge as they move towards a complete model of trust (Lovett, Simmons, and Kali, 1999).

Obviously, much more research needs to be done, particularly using empirical analyses to support the many possible theories about guanxi and the rule of law. Hopefully, this article is another step forward.

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