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Coping With Uncertainty: The Role of Contracts in Russian Industry During the Transition to the Market

*Kathryn Hendley**

I. INTRODUCTION

In the decade following the collapse of the Soviet Union, Russia earned a reputation for being a chaotic environment for business. Some commentators went so far as to label it as the “Wild East,” a scary place where law was largely irrelevant and criminal gangs held sway.¹ This image of the Russian business climate during the 1990s was generated primarily by journalistic accounts, which tended to highlight the activities of those who had figured out how to profit from privatization.² Though undeniably fascinating, these so-called oligarchs were not the norm. Arguably, an understanding of how garden-variety firms coped with the uncertainty wrought by the transition away from state socialism is more revealing of the true nature of the post-Soviet economy and the role of law in it. In a series of articles, I have begun to fill this gap in the literature by exploring the day-to-day reality of life for industrial enterprises in Yeltsin’s

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¹ See e.g., Seymour M. Hersh, *The Wild East*, ATLANTIC MONTHLY, June 1994, at 61–86; Viktor M. Sergeev, *THE WILD EAST: CRIME AND LAWLESSNESS IN POST-COMMUNIST RUSSIA* (1998); *THE WILD EAST: NEGOTIATING THE RUSSIAN FINANCIAL FRONTIER* (Peter Westin Ed., 2001).

² See e.g., STEPHEN HANDELMAN, *COMRADE CRIMINAL: RUSSIA’S NEW MAFIYA* (1997); DAVID SATTER, *DARKNESS AT DAWN: THE RISE OF THE RUSSIAN CRIMINAL STATE* (2004); DAVID HOFFMAN, *THE OLIGARCHS: WEALTH AND POWER IN THE NEW RUSSIA* (2003); ROSE BRADY, *KAPITALIZM: RUSSIA’S STRUGGLE TO FREE ITS ECONOMY* (2000).

Russia.³ The picture that emerges is more nuanced than the stereotype of industry beholden to the mafia that the popular media has perpetuated.

In this article, I turn my attention to the role of contracts. Both the scholarly literature and the popular media downplayed the relevance of contracts in Russia during the 1990s, arguing that weaknesses in the substantive law and the judicial system rendered contracts virtually unenforceable.⁴ Indeed, in a 1994 speech at the Kellstadt Graduate School of Business at DePaul University, the then-Chairman of the Board of Governors of the Federal Reserve, Alan Greenspan, said that “[t]here is no law of contracts” in Russia.⁵ The very fact that such a claim, which is preposterous on its face, could be made by someone of Greenspan’s stature illustrates the almost hysterical attitude that prevailed toward the Russian business environment. The reality was far less sensational. While the laws on the books in Russia governing contracts were far from ideal (much like the flawed contract law in other countries), they provided an adequate framework for doing business. Likewise, the economic (or *arbitrazh*) courts that handled contractual disputes between firms had their problems but were capable of resolving contractual dispute and enforcing their decisions.⁶ But Greenspan’s implication that the post-Soviet Russian economy was deeply dysfunctional was accurate. How could it have been otherwise? In the 1990s, Russia was in the midst of an unprecedented shift away from state socialism toward some form of market capitalism.⁷ The

³ See e.g., Kathryn Hendley, *The Role of In-House Counsel in Post-Soviet Russia in the Wake of Privatization*, 17 INT’L J. OF THE LEGAL PROF. No.1 (2010) [hereinafter “Hendley, *In-House Counsel*”]; Kathryn Hendley, *Beyond the Tip of the Iceberg: Business Disputes in Russia*, in ASSESSING THE VALUE OF LAW IN TRANSITION ECONOMIES, 20–55 (Peter Murrell ed., 2001); Kathryn Hendley, *How Russian Enterprises Cope With Payments Problems*, 15 POST-SOVIET AFFAIRS 201 (1999).

⁴ See Hersh, *supra* note 1; See also Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1924–29 (1996).

⁵ Alan S. Greenspan, *Thoughts About the Transitioning Market Economies of Eastern Europe and the Former Soviet Union*, 6 DEPAUL BUS. L.J. 1, 8 (1994). Greenspan was not alone in making claims about the lack of substantive law in Russia in the 1990s. See e.g., Louis Uchitelle, *The Art of a Russian Deal: Ad-Libbing Contract Law*, N.Y. TIMES, Jan. 17, 1992, at A1.

⁶ On the *arbitrazh* courts, see generally Katharina Pistor, *Supply and Demand for Contract Enforcement in Russia: Courts, Arbitration, and Private Enforcement*, 22 REV. OF CENT. & E. EUR. L. 55 (1996); Kathryn Hendley, *Remaking an Institution: The Transition in Russia from State Arbitrazh to Arbitrazh Courts*, 46 AM. J. COMP. L. 93 (1998). On the question of enforcing decisions of *arbitrazh* courts, compare Jonathon R. Hay & Andrei Shleifer, *Private Enforcement of Public Laws: A Theory of Legal Reform*, 88 AM. ECON. REV. 398 (1998) (contending that slowness, corruption, and inability to enforce judgments makes the *arbitrazh* courts unappealing) with Kathryn Hendley, *Enforcing Judgments in Russian Economic Courts*, 20 POST-SOVIET AFF. 46 (2004) (documenting through an empirical investigation of 100 non-payments that creditors were able to enforce judgments in about two-thirds of the cases).

⁷ See generally ANDERS ÅSLUND, *HOW RUSSIA BECAME A MARKET ECONOMY* (1995).

transition process was undeniably messy and painful for most Russians.⁸ A lack of confidence in the state's commitment to protecting property rights may have contributed to this dysfunction. More important, however, were the weakness of reputational sanctions for contractual breaches and the lack of reliable information about the creditworthiness of potential trading partners.

How did Russian industrial firms cope in this environment of profound uncertainty? To what extent did they use written contracts? Did their use of contracts necessarily translate into reliance on them when customers reneged? I began to explore these questions as part of my collaboration on a 1997 survey of 328 industrial firms fielded in six regions of Russia.⁹ The survey was aimed at understanding how business was being conducted in the transition context.¹⁰ We surveyed four key officials at each firm: the general director, and the heads of the sales, procurement, and legal departments. Among the most surprising findings was that almost all (85%) of the surveyed firms relied heavily on contracts.¹¹ For the most part, standard form contracts developed by sellers served as the basis for these agreements. The survey allowed us to capture these firms' behavior at a particular moment in time, but did not permit an in-depth investigation into how contracts were being used.

To learn more, I carried out a series of six case studies, selected from among those that had participated in our 1997 survey.¹² The sample variation of the survey in terms of the size, age, ownership, access to legal expertise, and industrial sector was replicated to the maximum extent possible given the challenge of gaining access.¹³ The case studies were

⁸ In the years following the break-up of the Soviet Union, Russia suffered economic setbacks worse than those experienced by the United States in the Great Depression. Between 1989 and 1994, industrial production decreased by an astounding 50%. See Michael S. Lelyveld, *Russia's Collapse Worst of Century*, J. COMM., Nov. 14, 1996, at 1A. For a sense of how it impacted daily industrial life, see David Hoffman, *The Russian Economy's Big Black Hole*, WASH. POST, Dec. 9, 1996, at A1.

⁹ The survey was conducted in Barnaul, Ekaterinburg, Moscow, Novosibirsk, Saratov, and Voronezh.

¹⁰ For background on the survey and a summary of results, see Kathryn Hendley, Peter Murrell & Randi Ryterman, *Law, Relationships, and Private Enforcement: Transactional Strategies of Russian Enterprises*, 52 EUR-ASIA STUD. 627 (2000).

¹¹ This statistic was generated from a series of questions in which we asked respondent firms to provide information about a recent transaction in order to assess the use of contracts. See Kathryn Hendley, Peter Murrell & Randi Ryterman, *Do Repeat Players Behave Differently in Russia? Contractual and Litigation Behavior of Russian Enterprises*, 33 LAW & SOC'Y REV. 833, 837 (1999).

¹² In the course of that survey, we asked the general directors whether they might be amenable to having a foreign scholar carry out a case study at their enterprise. Only those enterprises that indicated some willingness were approached. This excluded 25% (eighty-three firms) of our sample. For details on the composition of the sample and other information about the survey, see Hendley et al., *supra* note 10.

¹³ Dr. Alla V. Mozgovaya of the Institute of Sociology of the Russian Academy of

evenly divided between Ekaterinburg, Moscow, and Saratov. The case study approach is well-suited to research aimed at understanding an ongoing process. By talking to those involved in the contracting process and reviewing the files during the several weeks I spent at each firm, I have been able to bring the somewhat blurred snapshots obtained through the survey into sharper focus. The sustained contact allowed me to dig deeper than is possible in research that is based on single interviews.¹⁴ The case studies provide a fascinating glimpse into how Russian managers coped when faced with profound uncertainty. Among the six case studies, three different patterns emerged. The analysis not only provides a missing piece of the story of the transition, but also is instructive to the larger community of developing countries, many of which face the same pressures today as Russia was experiencing in the late 1990s.

The timing of the case studies was fortuitous in that enterprise management had had more than five years to adjust to the end of state planning and that it was just before the global financial crisis of the summer of 1998, which hit Russia hard. The research captures an important moment in time. Presented as archetypes, the case studies reflect general patterns of behavior. At the same time, the case study method has limitations. Though providing a window into the behavior of enterprise managers and underlying motivations, the extent to which these behavioral patterns are representative is unclear. To the extent possible, I have made use of the survey data to provide a broader context. The case studies are also limited by time, but they uncover deeply-seated attitudes. What has happened in the time since my case studies remains for future investigation.

II. THE ROLE OF TRUST IN CONTRACTUAL RELATIONS

Before turning to the case studies, it is worth reflecting on when contracts are useful. In Russia, as elsewhere, written contracts are rarely

Sciences in Moscow, who had coordinated the 1997 survey, negotiated initial access for me. I then had to convince management to let me stay. Dr. Mozgovaya found that many enterprises were nervous about the presence of a foreigner. Thanks to the earlier survey, I began each case study with a wealth of basic information about the enterprise. This greatly expedited my research, as compared with my earlier case studies. See e.g., Michael Burawoy & Kathryn Hendley, *Between Perestroika and Privatisation: Divided Strategies and Political Crisis in a Soviet Enterprise*, 44 SOVIET STUD. 371 (1992); Kathryn Hendley, *Struggling to Survive: A Case Study of Adjustment at a Russian Enterprise*, 50 EUR-ASIA STUD. 91 (1998).

¹⁴ In my own work at Russian industrial firms, I found that in the first meeting respondents often puffed up their role and the extent of extra-legal activity of the firm. As my presence became more routine, the real story gradually emerged. This is not to minimize the contribution of those who have had to rely on more limited contact, but only to suggest that some of the wilder claims made by respondents ought to be taken with a grain of salt. See e.g., ALENA LEDENEVA, *HOW RUSSIA REALLY WORKS: THE INFORMAL PRACTICES THAT SHAPED POST-SOVIET POLITICS AND BUSINESS* (2006); VADIM VOLKOV, *VIOLENT ENTREPRENEURS: THE USE OF FORCE IN THE MAKING OF RUSSIAN CAPITALISM* (2002).

mandatory. This is especially true for the sorts of simple transactions—buying raw materials and other inputs and selling outputs—that dominate the business lives of the case study firms. The statutory law in most countries contains default rules that govern a transaction in the absence of a written agreement to the contrary. In Russia, these terms are set forth in the Civil Code.¹⁵ In a decisive break with the Soviet past, the Civil Code grants almost complete freedom to the parties to set the parameters of their agreements.¹⁶ This includes the choice as to whether to rely on the Code's default rules or to set out their own agreement in writing.¹⁷ The decision to utilize a written contract is not predetermined, but is an affirmative strategic decision. Likewise, having a written contract does not necessarily translate into reliance upon it by either or both of the signatories to the contract. Studying the use of, and reliance upon, written contracts provides insight into the relationships of the case study enterprises with their trading partners and, more generally, their confidence in the legal system.

The ability of the relationship between trading partners to shape the contracting process is well accepted. Stewart Macaulay's "preliminary study"¹⁸ provides a foundation for much of the empirical and theoretical work that has followed.¹⁹ He argued that contracts fade in importance when the parties have confidence in one another.²⁰ Written contracts may still nominally govern the transaction, but in reality, they mostly gather dust in a

¹⁵ Civil Code of the Russian Federation [hereinafter "Civil Code"] arts. 420–53 (Peter B. Maggs & Alexei N. Zhiltsov eds., 2003). Part I of the Civil Code, which includes the provisions governing contractual relations, was adopted in November 1994 and so was in effect at the time of the case studies. *Grazhdanskiy kodeks RF (chast' pervaya)*. *Sobranie zakonodatel'stva Rossiiskoi Federatsii*, [Civil Code (part 1), Collection of Legislation of the Russian Federation] no. 32, item 3301, 1994.

¹⁶ Civil Code art. 421.

¹⁷ Though oral contracts are permitted under Russian law, they are rare in the Russian context because the insistence on documentary evidence of contractual obligations in the procedural rules makes them almost impossible to enforce in court. Civil Code art. 159. *Arbitrazhnyi Protsessual'nyi Kodeks [95 APK]* [Code of Arbitration Procedure] art. 60 (Russ. 1995). *Vestnik Vysshego Arbitrazhnogo Suda* [Bulletin of the Higher Arbitrazh Court], 1995, No. 6 [monthly], at 25–79. This procedural code was subsequently revised in 2002, but this feature of the code remained unchanged. Because my research focuses on the situation in Russia in the late 1990s, the 1995 APK is the relevant statute. For an overview of the changes wrought by the 2002 law, see Kathryn Hendley, *Reforming the Procedural Rules for Business Litigation in Russia: To What End?*, 11 *DEMOKRATIZATSIYA* 363 (Summer 2003).

¹⁸ See Stewart Macaulay, *Non-Contractual Relations in Business: A Preliminary Study*, 28 *AM. SOC. REV.* 55 (1963).

¹⁹ Both the literatures on relational contracting, see e.g., Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations Under Classical, Neoclassical, and Relational Contract Law*, 7 *Nw. U. L. REV.* 854 (1978), and on institutional economics, see e.g., Oliver E. Williamson, *Credible Commitments: Using Hostages to Support Exchange*, 73 *AM. ECON. REV.* 519 (1983), owe an enormous debt to Macaulay's original insights.

²⁰ See Macaulay, *supra* note 18.

file cabinet.²¹ They regain their importance when one of the parties fails to live up to the expectations of the other. Even then, the first response is rarely to consult the fine print of the contract, but rather to figure out how to repair the damage to the relationship.²² The wronged party will pursue his remedies under the contract only when convinced that the relationship is irreparably broken.²³

This confidence—or trust—that binds trading partners together can stem from a variety of sources. Though a full discussion of how trust transpires is beyond the scope of this article, the basis of the trust arguably influences contracting behavior and, therefore, deserves a few words. Williamson's distinction between personal and calculative trust is a good starting point.²⁴ Both types of trust provide a foundation for doing business without much attention to legal niceties (including written contracts). The differences in how they arise and take shape contribute to divergent responses when difficulties occur. Personal trust grows out of human interactions.²⁵ Typically this involves sustained contact between two firms through which managers gain confidence in one another and come to rely more on their counterpart's assurances than on the terms of the written contract. It can also arise when a preexisting friendship between managers at two firms is used to ignite a mutually beneficial trading partnership. Contracts, whether written or implied by law, are beside the point. If the problems arise, the parties prefer to use non-confrontational methods to find some middle ground that will allow the relationship to continue.

By contrast, calculative trust is grounded in a rational actor model that assumes all concerned are working to maximize their own interests.²⁶ As the label implies, it is not based on friendship but on need. For this reason, Williamson rails against labeling it as trust, preferring to see it as a

²¹ *Id.* at 59.

²² *Id.* at 61.

²³ *Id.* at 63–64.

²⁴ See Oliver E. Williamson, *Calculativeness, Trust, and Economic Organization*, 36 J.L. & ECON. 453 (1993). For a useful overview of the voluminous literature on trust, see generally Christel Lane, *Introduction: Theories and Issues in the Study of Trust*, in TRUST WITHIN AND BETWEEN ORGANIZATIONS: CONCEPTUAL ISSUES AND EMPIRICAL APPLICATIONS 1–30 (Christel Lane & Reinhard Bachmann eds., 1998).

²⁵ On personal trust, Williamson writes, “[s]uch relations are clearly very special . . . trust, if it obtains at all, is reserved for very special relations between family, friends, and lovers. Such trust is also the stuff of which tragedy is made. It goes to the very essence of the human condition.” Williamson, *supra* note 24, at 484.

²⁶ *Id.* at 463. For a critique of Williamson's concept of calculative trust, see Lawrence E. Mitchell, *The Importance of Being Trusted*, 81 B.U. L. REV. 591, 603–09 (2001). See also Lane, *supra* note 24, at 5; and Simon Deakin & Frank Wilkinson, *Contract Law and the Economics of Interorganizational Trust*, in TRUST WITHIN AND BETWEEN ORGANIZATIONS: CONCEPTUAL ISSUES AND EMPIRICAL APPLICATIONS 146–72, 148 (Christel Lane & Reinhard Bachmann eds., 1998).

pragmatic assessment of risk.²⁷ It ensues when two businesses are mutually dependent. The extent to which the two sides are equally matched in their need or, perhaps more accurately, their desperation for one another varies. Parity is the exception rather than the rule, which inevitably gives one side the upper hand in setting the terms of trade. At the core of calculative trust is suspicion. As a result, the parties tend to put more stock in the written contract and are likely to be quicker to resort to legal remedies when they run into problems. This, of course, assumes that the transaction takes place in an institutional environment where courts can be counted on to protect property rights.²⁸ There is no bright line between these two types of trust. A relationship that starts out as a rational calculation of self-interest can, over time, metamorphose into a friendship. Change in the other direction is also possible, typically occurring coincident with a change in personnel or a breakdown of the underlying amity.

Trading partnerships can also exist and flourish in the absence of trust. In such arms' length transactions, the parties are keen to find some way of guaranteeing their counterpart's performance. Written contracts can help assuage doubt. Other risk-minimizing strategies, such as requiring prepayment or imposing punitive damages for noncompliance, can be used in tandem with, or in lieu of, written contracts.²⁹

The use of, and reliance upon, contracts—whether written or oral—can also be influenced by a firm's faith in the legal system. This factor has been less thoroughly explored in the literature. Perhaps this is because the bulk of the theorizing as well as the empirical research has been grounded in the experience of the United States where a functional legal system is taken for granted.³⁰ This is not to idealize U.S. courts. Businesses have

²⁷ Williamson, *supra* note 24, at 463.

²⁸ In Williamson's words:

In effect, institutional environments that provide general purpose safeguards relieve the need for added transaction-specific supports. Accordingly, transactions that are viable in an institutional environment that provides strong safeguards may be nonviable in institutional environments that are weak—because it is not cost-effective for the parties to craft transaction-specific governance in the latter circumstances. Williamson, *supra* note 24, at 476.

In Lynne Zucker's work, she develops the concept of "institution-based" trust in which formal mechanisms are used to provide trust that does not rest on personal characteristics or on past history of exchange. Lynne G. Zucker, *Production of Trust: Institutional Sources of Economic Structure, 1840–1920*, 8 *RES. IN ORG. BEHAV.* 53, 61–62 (1986).

²⁹ See e.g., Edward H. Lorenz, *Neither Friends Nor Strangers: Informal Networks of Subcontracting in French Industry*, in *TRUST: MAKING AND BREAKING COOPERATIVE RELATIONS* 194–210, 198–201 (Diego Gambetta ed., 1988); Brian Uzzi, *The Sources and Consequences of Embeddedness for the Economic Performance of Organizations: The Network Effect*, 61 *AM. SOC. REV.* 674 (1996); Hendley et al., *supra* note 10.

³⁰ See, e.g., Macaulay, *supra* note 18; see also George L. Priest & Benjamin Klein, *The*

uniformly found litigation to be costly in terms of time and money.³¹ But such problems are leagues removed from those reported to plague the legal systems in Russia and other post-Soviet states.³² The widely-held perception that litigation is futile in Russia has been fueled by the relentless publication in major Russian newspapers of Dickensian horror stories of court cases gone horribly wrong.³³ My research reveals the extent to which the rumors about the shortcomings of the courts affected the use of, and reliance upon, written contracts. Logically, enterprises might shy away from written contracts if they are skeptical about the capacity of the courts to enforce them. On the other hand, relationships grounded in trust (especially personal trust) are based on an expectation of self-enforcement. Hence, the ability to enforce contracts via legal mechanisms is less consequential.

III. THE ROLE OF CONTRACTS IN THE SOVIET PLANNED ECONOMY

Just as firms' relationships with their trading partners and the perceived reliability of legal institutions can affect the appeal of written contracts, so too can firms' experience with using them. As in other countries making the transition from state socialism, contracts have a curious history in Russia. During the decades of Soviet power, the commitment to a planned economy constricted but did not obliterate the role of contracts.³⁴ To be sure, managers of Soviet state-owned enterprises were not allowed to pick their trading partners,³⁵ nor did they have much control over the terms of trade. The industrial ministries generated standard form contracts (*tipovye dogovory*) that enterprises were required to use. Thus, managers who came of age during the Soviet period were accustomed to using written contracts.

Arranging the specifics of the transactions was left to enterprise managers. Not surprisingly, the terms of the form contracts did not always

Selection of Disputes for Litigation, 13 J. LEGAL STUD. 1 (1984).

³¹ See generally Priest & Klein, *supra* note 30.

³² See generally John McMillan & Christopher Woodruff, *Private Order under Dysfunctional Public Order*, 98 MICH. L. REV. 2421 (2000).

³³ For a sampling of articles detailing disputes in the *arbitrazh* courts that had dragged out for over five years, see e.g., M. VolodaroVA, *Poka vlasti razburaiutsia—mozhet babakmut* [While the Powers Deliberate – Things Could Fall Apart], GUBERNSKIE VESTI (Sept. 1996) No. 37 [weekly], at 2; Irina Skibinskaia, *V bitve za aspirin nemtsi otstupaiut* [In the Battle for Aspirin, the Germans Are Retreating], INTEFAKS AIF, June 30, 1997; Aleksei Tarasov, *Lesoruby Sibiri mogut prevrat'sia v 'zelenykh'* [Siberian Lumberjacks May Lie About Turning into "Greens"], IZVESTIA, April 16, 1997.

³⁴ See generally Heidi Kroll, *The Role of Contracts in the Soviet Economy*, 40 SOVIET STUD. 349 (1988).

³⁵ See JAMES R. MILLAR, *THE ABCS OF SOVIET SOCIALISM* (1981) (giving an overview of the planning process in the Soviet Union).

suit their circumstances. Given that prices were a non-issue, disagreements tended to center on concerns over the quality of the goods to be supplied and the timing of their delivery. The form contracts could be adapted to particular circumstances through addenda, known as “protocols of disagreement” (*protokol raznoglasiia*).³⁶ Customers that were worried about getting shoddy goods or getting them in a less-than-timely fashion that might compromise their ability to meet the periodic output targets of the plan might attempt to alter the wording of one or more sections of the form contract in order to provide additional incentives to their suppliers. For example, they might move up the delivery date, impose some sort of punitive sanctions for non-compliance, or both. They would do this by sending a *protokol raznoglasiia* to the supplier in which they proposed new wording for one or more sections of the form contract. If the supplier was agreeable, its representative would sign the *protokol*, making it part of the contract and binding on the parties. But the supplier was not obligated to go along with the whims of its customers, and in light of the shortages that typified the Soviet economy, the supplier had considerable leverage. Often the parties went back and forth several times before agreeing on the final wording of the disputed sections.³⁷ Though these *protokoly* were cumbersome, they were an ingenious way of satisfying the bureaucrats as to the uniformity of transactions while incorporating just enough specificity at the edges to make them workable.

Though these relationships were not initiated voluntarily, the managers had to figure out a way to work together. Their shared difficulties, such as perennial shortages and overly optimistic production targets, created a kind of camaraderie that bound them together. Managers learned what they could expect from one another. They learned not just which suppliers lived up to their official obligations, but which of them could be counted upon to help out in a pinch. Production bottlenecks were a fact of life for these managers. They coped by hoarding key inputs but sometimes got caught short. In such cases, they might make an under-the-table appeal to their regular suppliers, recognizing that there would be a quid pro quo. Without these sorts of accommodations, the Soviet economy would have become immobilized.³⁸ Yet they were not part of the plan. Like all transactions that

³⁶ See Hendley et al., *supra* note 11, at 843–47 (analyzing how these instruments were used by firms that participated in the 1997 survey).

³⁷ This behavior is reminiscent of the “battle of the forms” familiar to scholars of U.S. contract law. See generally Victor P. Goldberg, *The “Battle of the Forms”: Fairness, Efficiency, and the Best-Shot Rule*, 76 OR. L. REV. 155 (1997); John E. Murray, Jr., *The Definitive “Battle of the Forms”: Chaos Revisited*, 20 J.L. & COM. 1 (2000).

³⁸ See generally JOSEPH S. BERLINER, *FACTORY AND MANAGER IN THE U.S.S.R.* (1957); DAVID GRANICK, *THE RED EXECUTIVE: A STUDY OF THE ORGANIZATION MAN IN RUSSIAN INDUSTRY* (1960) (providing a window into both the formal and informal mechanisms by which state-owned enterprises coped with the shortages that were endemic to the Soviet economy).

take place in the shadows, a modicum of trust among the participants was required. Sometimes this trust was grudging or, in Williamson's terms, calculative.³⁹ Not infrequently, the bunker mentality that pervaded Soviet industry allowed genuine friendships to blossom among trading partners. These friendships, in turn, made the underlying trading partnership stronger and more resilient.

To what extent did the use of written contracts translate into reliance upon them? If a supplier failed to deliver the goods on time or shipped shoddy goods, its customer had to find a way to get that supplier to live up to his word. After all, the customer could not seek out replacement goods; it had no alternatives to the supplier it had been assigned by the ministry. Nor could its production profile be adapted to take account of the unavailability of a key input. The specifications of the plan had to be met, both in terms of the quantity and type of goods produced. When confronted with this sort of problem, managers made every effort to persuade the recalcitrant supplier to perform.⁴⁰ However, the domino effect of shortages often made that impossible. Therefore, the managers' next step was to seek assistance from their bureaucratic superiors at the ministry or, failing that, from Communist Party officials. These officials did not act out of a concern for the sanctity of the contracts. In all likelihood, they were oblivious to the details of the contract. Instead, the officials got involved in order to ensure that the enterprise met its obligations under the plan. If the officials failed to do so, there would not only be a domino effect throughout the economy, but they and their subordinates would have to answer for the enterprise's shortfall (as would enterprise management). Political exigencies routinely trumped legal niceties. Though legal mechanisms existed that could, in theory, be used to compel the supplier to perform, they were rarely used. When they were, the goal was to signal that the failure to meet the plan targets was someone else's fault. No one actually thought that state *arbitrazh* (or *gosarbitrazh*), the administrative agency charged with handling disputes between state enterprises, had the power to override the wishes of the Party even if that is what a contract would seem to require.⁴¹ In the Soviet Union, power was concentrated within the Party and was exercised by its minions—not by legal institutions.⁴²

³⁹ Williamson, *supra* note 24, at 463.

⁴⁰ See generally Heidi Kroll, *Breach of Contract in the Soviet Economy*, 16 J. LEGAL STUD. 119 (1987) (illustrating how the contracting process worked in the U.S.S.R.).

⁴¹ See Stanislaw Pomorski, *State Arbitrazh in the U.S.S.R.: Development, Functions, Organization*, 9 RUTGERS-CAM. L.J. 61 (1977) (providing a thorough overview of how *gosarbitrazh* worked).

⁴² See ED A. HEWETT, *REFORMING THE SOVIET ECONOMY: EQUALITY VERSUS EFFICIENCY* 162–70 (1988) (describing the role of the Communist Party in the Soviet economy).

IV. THE SHIFT IN THE ROLE OF CONTRACTS IN POST-SOVIET RUSSIA

The role of contracts ostensibly changed with the collapse of the Soviet Union. Enterprise managers were empowered to pick their own trading partners and to determine their own terms of trade. Yet many “shotgun marriages” persisted. Information about alternatives was scarce and unreliable. Managers no doubt reasoned that the devil they knew was better than the one they didn’t. Somewhat ironically, the introduction of market mechanisms undermined the stability of trading relationships. Having grown accustomed to the state bailing them out during Soviet era,⁴³ enterprises were unprepared for the rigors of the market. They failed to pay for goods and services, and debts mounted quickly.⁴⁴ The efforts of enterprise managers to devise mechanisms for assessing customers’ creditworthiness fell short.⁴⁵ Duplicitous businessmen are of course not unique to Russia, but they gained a foothold that eluded them elsewhere due in large measure to the absence or weakness of key market institutions. Managers had no reliable way of checking the credit history of prospective clients.

As non-payment grew ever more commonplace, the inadequacy of reputational sanctions became apparent to all. The combination of a business culture that did not punish contractual breaches and a judicial system that made recovering through the courts difficult resulted in managers violating their contractual obligations with impunity. Non-payments dominated the docket of contractual disputes heard by the *arbitrazh* courts.⁴⁶ As I have documented elsewhere, only a tiny percentage of disputes involving non-payments were brought to the courts.⁴⁷ In the 1997 survey of 328 enterprises, general directors were asked to rank the

⁴³ These perennial bailouts are known as a “soft budget constraint.” Market reforms endeavored to “harden” budget constraints by forcing management to live within its means. See generally JÁNOS KORNAI, *THE SOCIALIST SYSTEM: THE POLITICAL ECONOMY OF COMMUNISM* 140–48 (1992) (discussing soft and hard budget constraints).

⁴⁴ See generally Barry W. Ickes & Randi Ryterman, *Roadblock to Economic Reform: Inter-Enterprise Debt and the Transition to the Market*, 9 *POST-SOVIET AFF.* 231 (1993); Selcuk Caner & Manouchehr Mokhtari, *Arrears and Their Implications for Economic Performance in the Russian Federation*, *RUSS. AND E. EUR. FIN. & TRADE*, Sept. –Oct. 2000, at 27.

⁴⁵ The survey findings show that enterprises used a credit rating agency to investigate the ability of customers to pay in only 4% of transactions. See e.g., Hendley et al., *supra* note 10, at 639.

⁴⁶ In 2001, over 95% of contractual cases resolved by the *arbitrazh* courts involved non-payments. *Sudebno-arbitrazhnaia statistika: Osnovnye pokazateli raboty arbitrazhnykh sudov Rossiiskoi Federatsii v 2000–2001 godakh*. *Vestnik Vysshego Arbitrazhnogo Suda* [Judicial-Arbitrazh Statistics: The Main Indicators of the Work of the Arbitrazh Courts of the Russian Federaion in 2000-2001, *Bulletin of the Higher Arbitrazh Court*], 2002, No. 4 [monthly], at 20–29.

⁴⁷ See Hendley, *Beyond the Tip of the Iceberg*, *supra* note 3.

seriousness of customer arrears on a zero to ten scale. Sixty percent of the respondents gave scores of seven or higher, with one-third giving scores of ten.⁴⁸ This clearly indicates the pervasive and critical importance of non-payments for Russian enterprises.

As the case studies illustrate, enterprises responded differently to the challenges posed by the persistent unwillingness and/or inability of their customers to pay. Some saw contracts as their salvation and devoted considerable energy to enhancing their remedies in case of non-performance. Others eschewed contracts, limiting themselves to doing business on the basis of prepayment and/or simple barter exchanges. The ephemeral nature of these transactions rendered contracts largely superfluous. Through the following case studies, the factors that shape enterprise behavior in this arena can be pieced together.

V. THE CASE STUDIES

A. Feigned Contracts

Moskovskaia Bytovaia Tekhnika (MBT),⁴⁹ located in the northern outskirts of Moscow, began producing consumer goods in 1923. Its production profile had been updated periodically to take account of advances in technology. Though consumer goods were something of an afterthought for the Soviet system, its trophy cases and walls were jammed with awards bestowed during the Soviet era. When I visited in early 1998, *MBT*'s primary output was men's electric razors, though management was experimenting with other home appliances, such as coffee grinders and juicers. *MBT* struggled to stay alive during the transition, as the Russian market had been flooded with foreign goods that were not only better quality and cheaper, but also more effectively marketed than *MBT*'s output. Between 1992 and 1997, 60% of the work force was laid off.⁵⁰ During the late 1990s, delays in the payment of wages averaged three months.⁵¹ When walking around the *MBT* facility, the silence could be deafening. Several managers spoke nostalgically about how the place used to bustle with activity. One commented to me that it had become a "ghost town."

MBT did not have its own stores. Its customer base was made up primarily of stores and kiosks located throughout Russia that were owned by others. The instability of the retail sector made their customer base unsteady and complicated the task of identifying new customers. Though

⁴⁸ *Id.* at 22.

⁴⁹ The names of the case study enterprises have been changed in order to preserve their anonymity.

⁵⁰ In 1992, *MBT* had 1,000 employees. By 1997, only 350 remained.

⁵¹ See generally PADMA DESAI & TODD IDSON, WORK WITHOUT WAGES: RUSSIA'S NONPAYMENT CRISIS 48-59 (2000) (discussing that wage delays were a common coping mechanism for Russian industrial firms during the transition).

MBT supplied over 300 retail establishments as of 1998, only about 20% were long-term customers. The remaining retail establishments were transient. The story was much the same for the procurement department. There was a core group of carryover suppliers from the Soviet era with which *MBT* worked regularly. But the downturn in *MBT*'s production level, which translated into smaller orders from suppliers, made it unappealing to many potential suppliers. As a result, the bulk of inputs were obtained from an ever-shifting group of suppliers.

MBT began life as a state-owned enterprise, but was transformed into an open joint-stock company through privatization in February 1993.⁵² As of 1998, most of the stock was held by outsiders, including a 42% stake owned by an American consumer goods company and a 25% stake retained by the Moscow city government. The five-person board of directors included *MBT*'s general director and another manager, as well as representatives of the American company and of the Moscow city government.

MBT relied on written contracts to govern its interactions with trading partners. Its behavior during the contracting process betrayed a selfishness—or perhaps more fairly, a self-protectiveness—almost surely borne out of the unstable economic conditions of the 1990s.

Like most manufacturers of consumer goods in Russia, *MBT* found its customers at trade shows. Its primary representative at these events was the sales director. She arrived with a stack of *MBT*'s form sales contracts that were pre-signed. These were made available to prospective customers at *MBT*'s booth. As might be expected, it was the sales director's job to convince buyers to sign up with *MBT*. Many did, but relatively few of these apparently fully executed contracts actually turned into real business for *MBT*. For example, when I spoke with the sales director in early 1998, there were over 300 of these form contracts in the files that had been signed by both sides, but she estimated that only about fifty-five of them represented ongoing relationships—that is, customers that ordered from *MBT* on a regular basis.

What explains *MBT*'s failure to honor the majority of contracts it executed at trade shows? The answer lies in *MBT*'s understanding of these documents. Though labeled as contracts, *MBT* did not regard them as binding. Technically they were not. The Russian Civil Code requires that sales contracts specify the type and quantity of goods.⁵³ *MBT*'s form sales contract sidestepped this requirement by moving this information into an

⁵² *MBT* privatized via Option 2, which allowed enterprise employees to purchase 49% of the capital stock under advantageous terms. There was a bit of skirmish between the general director, who favored Option 1, and the workers, who backed Option 2. See MAXIM BOYCKO, ANDREI SHLEIFER & ROBERT VISHNY, *PRIVATIZING RUSSIA* 76–81 (1995) (describing the three options for the privatization of state enterprises).

⁵³ Civil Code, *supra* note 15, at art. 455.

attachment. It provided that “[t]he Supplier is obliged to transfer and the Buyer is to accept and pay for goods in the assortment, quantity and in the term set forth in the Specification, or ‘Order of the Buyer,’ which is an integral part of the Contract.” But the details of this attachment were rarely negotiated at trade shows. In essence, what the sales director brought home were “feigned” contracts. They looked like contracts and contained many elements customarily found in contracts but, in actuality, they represented little more than an expression of interest on the part of the customer. They imposed no obligation on the part of *MBT* to ship goods, nor did they impose an obligation on the part of the buyer to accept or pay for goods.

Why bother? What advantage did *MBT* gain by collecting these “feigned” contracts at trade shows? The answer depends on whether or not a trading relationship develops. If it did not—that is, if *MBT* had no further inquiries from the prospective customer—then the “feigned” contract was worthless. The document simply gathered dust in *MBT*’s files. It was a lost opportunity for *MBT* but represented no real tangible cost because the sales director offered the form contracts on a take-it-or-leave-it basis at trade shows. On the other hand, if *MBT* received an order, then the seemingly meaningless language governed the transaction.

The form contract was four pages and laid out *MBT*’s expectations for both sides, including how and when the buyer was to make payment as well as *MBT*’s obligations regarding the quality of the goods. Having these additional terms in place and having the opportunity to frame them in language that best served its interests helped *MBT*. To be sure, the transaction could have gone forward without a written agreement between the parties on these issues. The order, taken together with the shipping documents and the affidavit of receipt, constituted a binding agreement, obligating the buyer to pay. In that case, however, any subsequent disagreement between the parties would be governed by the default rules contained in the Civil Code. The form contract allowed *MBT* to adapt these rules to its circumstances. It could not lower the bar, *i.e.*, the terms had to be within the parameters established by the Civil Code, but this still left it with a wide range of options. *MBT*’s form contract did not depart significantly from the Civil Code standards, but merely by clarifying the parties’ duties, it made it easier to go after delinquent customers. For example, the Civil Code allows the parties complete latitude in deciding when the buyer must pay for goods. If the contract is silent on this issue or if there is no written contract, then the Code provides that payment must be made within “a reasonable time after the origin of the obligation.”⁵⁴ Precisely what constitutes a “reasonable time” can vary based on a particular sector’s standards, giving rise to uncertainty.⁵⁵ By specifying a

⁵⁴ Civil Code, *supra* note 15, at arts. 314, 488.

⁵⁵ An influential commentary to the Civil Code argues that if the contract is silent, then the general rule is that payment has to be made within seven days. At the same time, the

time period, *MBT* left no doubt as to the liability of recalcitrant customers, thus providing little incentive for them to push the dispute into court, given that the outcome was not in question. In this way, having a written agreement lowered the transaction costs associated with disputing.

Even the combination of a signed form sales contract and a concrete order was not regarded by *MBT* as establishing a binding obligation to ship goods. Rather, it was treated as an offer, requiring *MBT*'s sales department to respond. This was the moment of truth for *MBT*. Acceptance hinged on the sales director's assessment of the creditworthiness of the customer. She was constantly refining her evaluation strategy, to little avail. In the wake of the collapse of the planned economy, her informal networks had broken down. She used to check on the veracity of customers' claims with her counterparts at other enterprises, but no more. She could no longer be sure that the information she received from these counterparts was accurate or complete. Experience taught her that glowing recommendations had often been bought and paid for by customers. She had long ago stopped relying on what the customers told her about their credit history. Indeed, she told me that she no longer bothered to ask them much about their track record, certain that they would embellish the truth and believing that merely asking the questions would mark her as naïve. Formal indicators of solvency had likewise let her down. By the time I encountered the sales director, her cynicism was in full flower. In her view, any document—whether a bank certification of enterprise solvency or an affidavit from the tax inspectorate—could be forged and was regularly forged by unscrupulous customers. Indeed, she related as typical the example of a customer who fabricated an entire set of supporting documents, everything from a corporate charter to bank statements. This left her at an impasse. Though charged with weeding out the untrustworthy customers, she was unable to find reliable predictors of customer behavior.

How, then, did the *MBT* sales director maneuver through this minefield of mendacity? She cobbled together a strategy that combined her intuition about prospective customers with formal documentation of their existence and credit history. My review of the files indicated that the documents most commonly demanded were: (1) copies of corporate charters along with evidence that they had been registered with the appropriate state authorities; (2) affidavits from the bank(s) where the customers had accounts documenting their balance and verifying that no liens were pending; and (3) certification as to their good standing with the tax inspectorate. For example, a file for a store in Saratov contained an affidavit from its bank confirming that, “the enterprise is financially stable,

commentary authors also note that this presumption can be challenged based on sectoral standards. *Kommentarii chasti pervoi grazhdanskogo kodeksa Rossiiskoi Federatsii dlia predprinimatelei* [Commentary on Part One of the Civil Code of the Russian Federation for Entrepreneurs], 277 (M.I. Braginskii ed., 1996).

it fulfills its payment obligations in a timely and complete fashion, and has no debts at the bank.” Another file for a Moscow department store included a handwritten note that it “pays badly,” though the source of that conclusion was unclear. Sure enough, *MBT* declined to ship goods to that store. In the relatively rare instances when the customer was an individual rather than a legal entity, the sales director’s natural suspicion was heightened because she realized that individuals were inherently more slippery than firms. As a rule, she required cash up front from individuals. Even then, she demanded that they provide her with copies of their passport in order to document their existence. This documentation, where present, certainly informed her decision but was not conclusive. Indeed, of the forty-seven contracts dealing with sales from 1997 that I sampled from *MBT*’s files, less than half (nineteen or 40.4%) had supporting documentation. In the final analysis, the sales director relied on her gut instinct. She had headed the sales department since *MBT*’s privatization and, consequently, had an encyclopedic knowledge of its customer base. Though she did not trust any of her customers completely, she trusted her ability to detect unacceptable levels of duplicity and was comfortable taking sole responsibility for deciding whether to go forward with a proposed sale.

Once there was an agreement in principle⁵⁶ to go forward, the two sides had to agree on terms. Not all prospective customers were comfortable with the conditions set forth in *MBT*’s standard contract. The sales director (not the in-house lawyer) was the face and voice of *MBT* during any bargaining.⁵⁷ Although she avoided lengthy negotiations during trade shows, she was willing to follow up and work with interested customers to reach an accord. She did, however, insist on using *MBT*’s form contract as the starting point because she did not want to expend her staff’s time evaluating other enterprises’ form contracts. Relatively few customers objected.⁵⁸ It was standard practice for the seller’s form to serve as the basis for sales contracts. The two sides then worked out their differences by using “protocols of disagreement.” As I note above, this practice evolved during the Soviet period when enterprises were required to

⁵⁶ This agreement was akin to the “blanket orders” used in many sectors of U.S. industry. Just as with “blanket orders,” *MBT*’s customers would send orders from time to time when they needed a specific number of razors. See generally Caroline N. Bruckel, *Consideration in Exclusive and Nonexclusive Open Quantity Contracts Under the U.C.C.: A Proposal for a New System of Validation*, 68 MINN. L. REV. 117, 140–52 (1983); Stewart Macaulay, *The Standardized Contracts of the United States Automobile Manufacturers*, 7 INT’L ENCYCLOPEDIA COMP. L. Ch. 3, Sec 3-21 to 3-30 (1973).

⁵⁷ For more on the role of the in-house counsel at *MBT*, see Hendley, *In-House Counsel*, *supra* note 3.

⁵⁸ Some of the large department stores in Moscow refused to use vendors’ form contracts. Their rationale mirrored that of *MBT*, namely they do not want to waste staff time analyzing other firms’ contracts. According to the sales director, *MBT* passed on sales under those circumstances, advising the store to buy *MBT*’s goods through a middleman who was willing to accede to the store’s terms.

use form contracts generated by the industrial ministries. I was surprised that this somewhat awkward method of revising contracts persisted in an era in which freedom of contract had been reestablished. When I asked *MBT's* in-house lawyer about this, she reacted defensively, pointing out that nothing in the revised Civil Code precluded the use of these *protokoly*. I agreed, but asked whether, in an age of computer-generated contracts, it might not be more efficient to incorporate the agreed-upon changes into a new contract rather than gumming up the file with numerous *protokoly*. I noted that in my review of *MBT's* records, I had found several files in which the parties had circulated a *protokol*, which had not been signed by both sides, thereby creating doubt as to the terms of the contract.⁵⁹ She conceded that this was a disadvantage to the *protokol* system but said that she was more comfortable carrying on as she had been trained. Despite what appeared to my outsider's eyes to be the patent inefficiency of *protokoly*, the sales department agreed.

According to the sales department personnel, the use of *protokoly* was the exception rather than the rule. My review of *MBT's* files provided further confirmation. Of the forty-seven contracts I sampled from 1997, only nine (19.2%) included a *protokol*.⁶⁰ The issues raised were predictable. Typically, they related to payment terms, quality concerns, or remedies for non-performance. *MBT's* form contract did not predetermine the number of days within which the customer had to pay, leaving this decision to the discretion of the sales department. As a rule, customers were required to pay within twenty days of receipt of the goods. Requests for longer grace periods were granted only if the quantities involved were unusually large. *MBT* was less troubled by requests for modifications in the terms governing quality standards. Without exception, such requests were granted in the files I reviewed.⁶¹ But *MBT* was more persnickety when it came to potential sanctions for contractual breaches by buyers. Its form contract provided for penalties on late payments in the amount of 0.05% per day of the amount owed.⁶² Not surprisingly, customers tried to pare down

⁵⁹ Three of the nine contracts that had *protokoly* were not fully executed. Goods had been shipped to these three customers. The files did not indicate any difficulties over payment and, therefore, the terms of the contract receded in importance. Had problems arisen, the lack of clarity over whether the proposed revisions had been accepted by both sides would have complicated the task of collecting. This is analogous to the problem that arises in U.S. contract law when trading partners exchange forms and neglect to pay attention to the discrepancies between the so-called "boiler plate" language. See Macaulay, *supra* note 18, at 59–60 (discussing the battle of the forms).

⁶⁰ This corresponds with the incidence of *protokoly* reported in the survey. The mean percentage of contracts that involved a *protokol* for the respondent enterprises was 20.6%. It is worth noting that a significant number of surveyed enterprises (23%) had no experience whatsoever with *protokoly*.

⁶¹ Two-thirds of the *protokoly* (six of nine) asked for changes to the section(s) of *MBT's* standard contract dealing with the quality of its goods.

⁶² The evolution of the rules governing punitive damages is set forth below. See *infra*

this obligation. About half of the *protokoly* (five of nine) called for changes to the penalty clause. Some even tried to eliminate it. The sales director was uniformly unsympathetic to such demands. If a customer pressed the point, she tended to walk away. Given that the provision became relevant only in case of non-payment, she worried that an insistence on lower-than-normal penalties was an indicator of an intention not to pay. She told me that she often responded to such customers by asking, “do you want to work with us or litigate?” *MBT* was less dogmatic when it came to the provision of its form contract that fined customers for returning goods; it acceded to all requests to void that section.

With or without *protokoly*, the contracts between *MBT* and its customers were simple and straightforward. They documented the agreement between the parties and guaranteed *MBT* the broadest possible spectrum of remedies in the event the customer failed to remit payment. The sales department was adamant about the need for written contracts with all customers, yielding only for spot sales. Yet when the terms of *MBT*'s form contract are compared to the Civil Code's default rules, it becomes clear that the legal burdens imposed are almost indistinguishable. The Civil Code contemplated the penalties that the sales department forced on reluctant customers, and the Code did not require any special agreement between the parties. But no one at *MBT* had done this analysis. Though they claimed that their insistence on written contracts was motivated by a desire to maximize *MBT*'s legal protection, the more likely explanation was that they used contracts because they had always used contracts. Interestingly, for *MBT*, having the signed contract in hand seemed to provide a sense of comfort. No doubt having written contracts was appealing because it sent a signal to their customers that the agreement was being taken seriously and that failure to live up to the promises made in the contract would carry consequences. In an era when non-payments had become commonplace, *MBT*'s managers were eager for their customers to understand that they would not tolerate such behavior. As I have documented elsewhere,⁶³ the *MBT* sales department did not tolerate non-payments and had no compunctions about suing recalcitrant customers.

Like most Russian consumer goods manufacturers in the 1990s, *MBT* was eager to find new markets but had to be constantly on guard against customers that could not or would not pay for goods. In a perfect world, *MBT* would have protected itself by demanding payment in advance of shipment. But the market for household appliances was very competitive. In the view of the sales director, if *MBT* had insisted on full prepayment, its orders would have dried up. She did require a down payment from new customers but waived it after about six months of steady trading. Rather than protecting *MBT*'s interests by consistently requiring prepayment, she

Part VI. p. 137–39.

⁶³ Hendley, *supra* note 3, at 23–29.

did so by picking and choosing among the potential customers. This was certainly her right, but the way she went about it had the effect of mutating what appeared to be a bilateral contract—a set of mutual obligations—into a unilateral contract under which *MBT* was calling the shots. Once a customer had signed the contract, *MBT*'s duty to ship goods should have been triggered by its receipt of an order. Yet the sales department persisted in treating each order as a discrete offer, which it was free to accept or reject.⁶⁴ In late 1997, *MBT* went further by demanding that customers agree that *MBT* could change the price of its goods unilaterally if its costs increased, rendering negotiations over price pointless.⁶⁵ My review of other enterprises' contracts as a part of my research at *arbitrazh* courts suggests that such demands by manufacturers were common in Russia in the late 1990s. Having come of age in the Soviet system, which was characterized by unchanging prices for inputs and energy, the exponential increases that came with the transition to the market left Russian industrial managers nonplused. Like their counterparts elsewhere, *MBT* managers sought to transfer the risks associated with inflation to their customers. This was certainly understandable from *MBT*'s perspective, but it resulted in a skewing of responsibility and allowed *MBT* to back away at any time with no consequences.

MBT's behavior vis-à-vis its contractual partners demonstrates that contracts do not operate in a vacuum. They are adapted to serve the needs of those using them. *MBT* was trying to navigate in a sea of uncertainty. Not only were the prices of its inputs fluctuating wildly, but not paying for goods had become commonplace and carried no reputational sanctions. The institutions that it ought to be able to call upon for help, such as credit rating agencies and banks, were either absent or non-functional. Consequently, *MBT* devised a strategy that has allowed it to survive in the short run. It cast its nets widely for potential customers, even going so far as to sign contracts with anyone that expresses the slightest interest. But then it threw many of these customers away if the sales director could not satisfy herself of their creditworthiness. One shipment was no guarantee that a customer would be supplied in the future. The sales department never became complacent, nor did it allow itself the luxury of trusting in the rectitude of customers, regardless of how long the relationships had existed. This is not to say that the sales department was unmindful of the importance of relationships in building and sustaining a trading partnership. Rather, the sales director and her staff learned through painful experience not to presume that preexisting relationships or even personal friendships would guarantee contractual compliance. Interestingly, they did not regard

⁶⁴ By doing so, *MBT* signaled that it was not treating the base contract as a “blanket order.” See also Hendley, *supra* note 57, at 24.

⁶⁵ The text of one such telegram from a customer read: “We agree to receipt of goods at the prices of the supplier at the moment of shipment.”

contractual betrayals from long-term partners as personal betrayals, but as responses to the impossible situation of having debts outweigh income. They understood that a strong relationship could benefit them when a customer was making the tough choice of which suppliers to pay. At the same time, they were resigned to the reality that nothing could guarantee that they would always come out on the positive end of such calculations. As a result, trust grew ephemeral and took on a calculative quality. At *MBT*, a customer came to be only as trustworthy as its last transaction.

B. Phantom Contracts

Like many firms the world over, *MBT* looked to its contracts for protection only when all other alternatives had been exhausted. Even this limited reliance, however, required that its contracts be carefully drafted. By contrast, firms that used barter had little need for contracts.

Saratovskii Kauchuk (SK) had more difficulty adjusting to the post-Soviet reality than did *MBT*. Located near the center of Saratov, *SK* had been producing the hard plastic casing used by manufacturers of vehicle batteries since 1943. Enterprises that assemble cars, trucks, farm equipment, and aircraft made up its traditional customer base. Its fortunes were irrevocably tied to these assembly plants, and as the economic crisis slowed their production, *SK* was brought to its knees.⁶⁶ *SK* became an open joint-stock company as a result of privatization in December 1992.⁶⁷

SK survived thanks only to barter.⁶⁸ This tactic had not been much used during the Soviet era, but became a lifeline for many firms during the industrial decline of the mid- and late-1990s.⁶⁹ By 1998, *SK* was dependent on barter for 90% of its “sales” of output and its “purchases” of inputs. *SK*’s top management had resigned itself to this hand-to-mouth existence. The inability to ensure a steady supply of raw materials and other inputs gave rise to periodic work stoppages. One of these, which lasted about ten days, coincided with my fieldwork. Management had attempted to economize by going onto a four-day work week, but the long delays in

⁶⁶ For more information on what happened to key auto assembly plants, see Carol Matlack, *Anatomy of a Russian Wreck*, BUS. WK., Sept. 7, 1998, at 86 (reporting on Avtovaz); Gary Peach, *Mayor’s Industrial Policy Carries Big Costs*, MOSCOW TIMES, Dec. 8, 1998, at 1 (reporting on ZIL); Sujata Rao, *Renault, Moskvich Tout New Alliance*, MOSCOW TIMES, Nov. 4, 1997; Sujata Rao, *GAZ Deal Puts Fiat in Russian Race Again*, MOSCOW TIMES, Sept. 30, 1997.

⁶⁷ See BOYCKO ET AL., *supra* note 52, at 78–79 (discussing how, like *MBT*, *SK* privatized via Option 2).

⁶⁸ For background on the role of barter in the Russian economy during the 1990s, see generally Jan Amrit Poser, *Monetary Disruptions and the Emergence of Barter in FSU Economies*, 10 COMMUNIST ECONOMIES & ECON. TRANSFORMATION 157 (1998); see also Sergei Aukutsionek, *Industrial Barter in Russia*, 10 COMMUNIST ECONOMIES & ECON. TRANSFORMATION 179 (1998).

⁶⁹ In 1992, barter accounted for 20% of *SK*’s sales and 10% of its supply acquisitions.

wage payments evidenced the futility of these measures.⁷⁰ When I visited the plant in May 1998, workers had yet to receive any wages for that year. Their lack of hysteria indicated that they were accustomed to coping with this state of affairs. Those who could find other work had long since departed. Over half of the workforce had left—whether voluntarily or as a result of layoffs—since 1992. Only 880 workers remained. Those who stayed felt that *SK* was the best they could do.

At first glance, *SK* appeared to have grounded its relationships with trading partners in contracts. In my first few days at the enterprise, I found folders stuffed with fully executed contracts with customers in the files of the legal department. With only a few exceptions, *SK*'s form sales contract was used as a starting point, indicating management's desire to control the terms of the transaction. Not surprisingly, this was not always possible. Many of the executed contracts had numerous *protokoly* attached, thereby evidencing protracted negotiations over the contractual terms.

My conversations with the staff lawyers seemed to confirm the centrality of contracts to *SK*'s business transactions.⁷¹ They stressed the importance of memorializing agreements in the form of written contracts. Although they understood that such written documentation was not required under Russian law, given that an exchange of letters or any sort of acknowledged receipt of goods by a customer could be enforced in the *arbitrazh* courts, they clearly felt more secure with a contract signed by both sides. The lawyers took considerable pride in *SK*'s form sales contract, having had primary responsibility for drafting and revising it. We had lengthy and detailed discussions of this document in which the lawyers laid out the reasoning behind the key provisions and explained how these provisions had evolved over time. The section dealing with penalties for non-payment had proven to be particularly vexing. At one time, they had specified the amount of the penalty to be charged to the delinquent customer, based on a percentage of the unpaid balance. In the most recent iteration, however, they had simplified the language, giving *SK* the right to pursue any remedy allowed under the Civil Code. This drafting decision preserved all possible options while giving *SK* management maximum flexibility in dealing with recalcitrant customers.

As I had the opportunity to talk with managers who were more involved with the day-to-day business at *SK*, I came to realize that, in the immortal words of Shakespeare, the stacks of contracts that I had reviewed were much ado about nothing. The head of the sales department put it bluntly when he told me that these contracts present an "artificial picture" of *SK*. For the most part, these contracts were never activated. They existed

⁷⁰ During the last quarter of 1996, 80% of *SK*'s employees had worked less than 40 hours per week.

⁷¹ For a fuller discussion of the role of *SK*'s lawyers in the firm's decision making, see Hendley, *In-House Counsel*, *supra* note 3.

due to a bizarre combination of inertia and adherence to a now-outdated etiquette. Each year, *SK* sent its standard form contract to the customers with which it had traditionally done business, irrespective of whether these customers had bought anything recently. Many of the trading partners that *SK* inherited from the Soviet era were assembly plants for cars, trucks, and military machinery. These enterprises never found their footing in the post-Soviet Russian marketplace, but in the late 1990s they still retained the aura of power they had earned during the decades of Soviet power. The machinery produced by these Russian plants, whether intended for the consumers or for the military, was unable to compete with Western imports. As demand dried up, their production shriveled. Yet they did not shut down, hoping against hope for a revival of interest in their output. By sending them sales contracts, *SK*'s management seemed to be acting as a kind of enabler, allowing these dinosaurs of the Soviet industry to save face. What was more curious was that the two sides went through elaborate negotiations over the terms of these contracts, even though both knew that they would likely never be activated. A case in point was the contract with a local factory that, prior to the collapse of the Soviet Union, had been one of the premier aircraft assembly plants in the country.⁷² In the Soviet era, being a supplier for such a plant would have been a feather in *SK*'s cap. No doubt loyalty and gratitude help explain why it was kept on the books as a customer long after its ability to purchase *SK*'s output had ceased. Less obvious is why *SK* engaged in prolonged negotiations with this plant, giving rise to tangible costs in the form of the time spent by *SK* managers, as was evidenced by the *protokoly* attached to the 1998 contract. After all, the two enterprises were just shadowboxing with one another. The aircraft assembly plant purchased none of *SK*'s output during 1997 and the sales department personnel anticipated no sales during 1998. The situation was similar with regard to other formerly powerful defense and auto assembly plants. So why bother with contracts? The sales director confessed that it was done as a courtesy to these former behemoths of Soviet industry. But these contracts, which constituted the bulk of those I reviewed at the legal department, were "phantom" contracts.

If its written contracts were illusory, then how did *SK* go about selling its battery blocks? For the most part, its sales took place either through in-kind exchanges or upon receipt of payment in advance. The sales director estimated that 90% of *SK*'s sales involved barter.⁷³ Sometimes these transactions involved a bilateral swap of goods. More often, however, *SK* had to put together chains of in-kind exchanges (*tsepochniki*) that would

⁷² For more background on this enterprise, see Hendley, *supra* note 13.

⁷³ Likewise, 90% of the supplies needed for production were acquired through barter. *SK* was an outlier among the surveyed firms. Among these firms, barter accounted for an average of 39% of sales and 42% of purchases of needed inputs. Hendley et al., *supra* note 10, at 640.

eventually yield the inputs it needed to sustain production. For *SK*, the first step was usually to trade its battery blocks for actual batteries that could then be bartered for much-needed inputs. Regardless of whether the barter arrangements were bilateral or multi-party, they were memorialized through an exchange of letters between the parties to each exchange (backed up by the bills of lading that accompanied the goods). This left *SK* somewhat vulnerable when it was part of a barter chain in that there was no single written contract that bound all the participants. This opened up the possibility that *SK* would end up with goods for which it had no use because the next link in the chain had been broken. This risk was considered negligible by the sales department personnel. They had cultivated relationships with several of the firms that had sprung up to broker deals among cash-poor enterprises during the 1990s,⁷⁴ and reasoned that these intermediaries would eventually be able to dispose of anything.⁷⁵ They were resigned to the reality that these barter transactions might produce losses for them in the short run. Given their lack of liquidity, they saw no other way of obtaining the inputs required to maintain production.

The sales department was similarly dismissive of the value of written contracts with regard to non-barter-related sales. Such sales were made only on the basis of full prepayment. Beginning in 1996, *SK* experimented with various payment regimes. Initially customers were granted a certain grace period, but *SK* kept getting burned. Management resolved that the only way to ensure payment was to have the payment in hand before the goods were shipped.⁷⁶ As a result, the protections afforded by written contracts were regarded as superfluous. An exchange of letters was viewed as sufficient.

Why did written contracts recede in importance for *SK* in the post-Soviet era? In the view of *SK*'s vice president for economic issues, contracts had "lost their legal strength." During the Soviet period, *SK*'s managers viewed contracts as sacrosanct. Contracts brought predictability and stability to the production process. They set forth the quantity of goods to be shipped to customers over the course of several years and allowed manufacturers to plan their production schedules. By the late 1990s, *SK*

⁷⁴ As a testament to the importance of these barter agents, a representative from one of the firms that helped *SK* arrange barter transactions was on its board of directors.

⁷⁵ For other examples of barter circles, see Ledeneva, *supra* note 14, at 120–41, which argues that less than 5% of all barter in Russian industry was bilateral.

⁷⁶ In principle, a letter of guarantee from a customer should constitute a binding and enforceable promise to pay. *SK*'s sales director has avoided them, noting that they are only as reliable as the enterprise that signs them. Because *SK* deals mostly with small and poorly capitalized companies, such letters were viewed as worthless. When I asked the sales director if he could imagine a situation when he would accept a letter of guarantee in lieu of prepayment, he responded that he would accept a letter of guarantee from the oblast government, but quickly noted that this was strictly hypothetical because *SK* had no business dealings with it.

found that a contract represented little more than an inchoate hope on the part of the customer that it would be able to purchase *SK*'s battery blocks. Contracts no longer imposed any responsibility or liability on either side. Because they provided no guarantee of sales, they lost their value for those close to the production process. Such guarantees came only with concrete orders, which did not have to be attached to formal contracts. The written contract laid out the terms that governed such orders, if they were forthcoming. But experience taught the sales department personnel at *SK* that signing a contract did not enhance the likelihood of orders. Consequently, they saw little point to going through the rigmarole associated with written contracts. Perhaps if the interactions with customers had been treated as ongoing, having a contract with mutually agreed-upon ground rules would have made sense. But *SK*'s practice of treating each transaction as discrete combined with its preference for simultaneous exchanges in barter-related transactions and full prepayment in cash-based transactions left few loose ends. If *SK*'s management was dissatisfied with the performance of a specific trading partner, they simply backed away from the transaction preemptively, thereby obviating any potential liability.

On a superficial level, the yearning of *SK* management for meaningful contracts expressed itself in the form of nostalgia for the Soviet system. As the vice president for economic issues told me, "life was better when economic relations were controlled centrally." Contracts were concluded for five years and, in his words, "meant something." His sentiments were echoed in separate conversations with top officials in the sales department. They were understandable. For an enterprise like *SK*, there is little doubt that life was easier under state socialism. As a downstream producer, the battery blocks *SK* manufactured were used primarily by battery makers who then marketed their wares to consumers and assembly plants. When everything was planned centrally, they had a prescribed set of customers and a guaranteed level of output. These guarantees dissipated with the end of central planning. Had the top management of *SK* been more resourceful, they might have found a path to profitability through new product lines or exports. But these managers, most of whom had been with *SK* for decades, were unable to adapt and to find their niche as market incentives were introduced.

As they looked back through the rosy glasses of nostalgia, *SK*'s management had conveniently forgotten the restrictions on its freedom of action that came along with state socialism. In reality, what these managers longed for was not a return to the past but a return to the sense of stability and normalcy that they took for granted during the decades of Soviet power. This sort of security is possible in a market economy, though achieving it requires different skills than did surviving within a planned economy. The revised Civil Code, which was the centerpiece of market reforms in Russia, reintroduced contractual freedom in business transactions after decades of

ministerial micro-management of trading relationships.⁷⁷ In a perfect world, this newfound flexibility would have opened up the possibility of introducing new products and attracting new customers, both within Russia and abroad. The reality, at least for *SK*, was darker. The absence of key market institutions, such as banks that were prepared to offer lines of credit to industrial enterprises and reliable credit-rating agencies, had a devastating impact on companies like *SK*.⁷⁸ Lacking access to the investment capital that might have allowed them to rethink their production profile and to information about potential untapped customer bases, *SK* was left scrambling to maintain its Soviet-era levels of production and customer base. The waves of inter-enterprise arrears that swept over Russian industry repeatedly during the 1990s only made matters worse as *SK* and its ilk adapted to, and struggled to survive in, a cash-free environment.

SK adapted by trusting no one. In Williamson's terms, the *SK* managers had given up on personal trust and had become calculative.⁷⁹ Recognizing that most of their customers' circumstances were just as precarious as their own, *SK*'s managers assumed duplicity on their part and acted accordingly. Their policy of requiring customers to pony up before transferring any *SK* output to them constitutes convincing evidence of the suspicion that had come to characterize their interactions with customers. In a world where no one can be trusted, businessmen typically rely on detailed written contracts to protect them. But not the *SK* managers. Even though they had a workable form sales contract at their disposal, they did not bother with it because they felt that the very nature of their sales transactions left no lingering liability. For the most part, they were right. Problems arose only when members of the sales department let down their guard and extended trade credit to a once-favored customer. Of course, this skepticism regarding the bona fides of customers did little to spur the development of long-term relationships among *SK* and its customers.

What is most interesting about *SK*'s decision to minimize their reliance on contracts is that it was not motivated by a lack of faith in the legal system. Rather, it was the "anything goes" business culture that drove *SK*'s behavior. Having been socialized in an era of state planning where managers did not have to worry about balancing the books, the generation of managers who were leading *SK* and its trading partners felt no shame when renegeing on contracts. By 1998, *SK*'s chronic inability to pay had driven away most of their suppliers. *SK*'s customers were similarly afflicted. In this context, written contracts receded in importance.

⁷⁷ Civil Code, *supra* note 15 at art. 421.

⁷⁸ See generally JULIET JOHNSON, *A FISTFUL OF RUBLES: THE RISE AND FALL OF THE RUSSIAN BANKING SYSTEM* (2000) (discussing the role of banks in Russia in the 1990s).

⁷⁹ Williamson, *supra* note 24, at 482–86.

C. Irrelevant Contracts

Venera, a manufacturer of women's underwear located in Ekaterinburg, differed from the other case studies in two critical respects. First, it was not a former state-owned enterprise.⁸⁰ The general director and his top lieutenants left jobs at an Ekaterinburg defense plant to create it in 1990, taking advantage of the Gorbachev-era legislation that legalized new forms of property ownership.⁸¹ In 1998, *Venera* was a closed joint-stock company with only twenty shareholders. Ninety-eight percent of its stock was owned by top management, with the general director holding a controlling interest.⁸² The remaining 2% was held by a former manager who left to start his own company. Not surprisingly, the board of directors was composed solely of insiders.

Second, *Venera* was a profitable and growing business. It first set up shop in a few rooms in an unused production space on the outskirts of Ekaterinburg.⁸³ Over time, it purchased new capital equipment and expanded to fill the entire building. It was less hampered by debt than the other case study firms. It did not rely on barter. *Venera* fulfilled its contractual obligations in a timely fashion and expected the same from its trading partners, though defaults sometimes occurred.⁸⁴ Wages were occasionally delayed, but usually by days, not months.⁸⁵ From time to time, it was delinquent in paying its tax obligations, but this was a short-term problem, not a perennial sword of Damocles, as was the case for *MBT* and *SK*. Its most serious debts were to local banks for operational loans.⁸⁶ *Venera's* success made it attractive to local bankers—at least prior to the crash of August 1998⁸⁷—and its loans were negotiated at arm's length.

The company began life as a cooperative that, according to the general director, made an extraordinary amount of money “speculating” in deficit

⁸⁰ 12% of the surveyed enterprises had never been state-owned.

⁸¹ See generally Peter B. Maggs, *Legal Forms of Doing Business in Russia*, 18 N.C. J. INT'L L. & COM. REG. 173 (1992).

⁸² All of these manager-shareholders were men. Even more intriguing, they uniformly took great pride in the fact that their wives did not work outside the home.

⁸³ Management provided a bus service for workers.

⁸⁴ As part of the survey, the general director was asked to assess the seriousness of customers' arrears to *Venera* on a zero to ten scale. He gave it a score of nine, indicating that he regarded it as a very serious problem.

⁸⁵ Wage payments were delayed by ten days in April 1998, and by five days in May 1998.

⁸⁶ Neither *MBT* nor *SK* had substantial bank loans. When asked as part of the survey to assess the seriousness of arrears to banks on a zero to ten scale, both responded zero. By contrast, *Venera* gave a score of nine. *Venera's* indebtedness to banks marks it as somewhat unusual among the surveyed enterprises. More than 60% of these enterprises responded like *MBT* and *SK*, with a score of zero. The mean response among all surveyed enterprises was 2.1.

⁸⁷ For background on how the global economic crisis of 1998 affected Russian banks, see Johnson, *supra* note 78, at 201–24.

goods.⁸⁸ It grew from five employees in 1990, to ninety in 1992, to 300 in 1998. At the outset, the only real asset was the general director's access to key officials at the ministry of construction, with whom he became friendly while working at the defense plant. Recognizing that profiteering would wane when state controls on prices were lifted, he began two lines of manufacturing: parts for television and women's underwear. He and his staff had no prior experience with either. Within a few years, it became clear that the greatest opportunities were in producing underwear. It was a market niche that had been neglected during the decades of Soviet power. Women were weary of the utilitarian styles of undergarments that had been available to them. Perhaps because it was a start-up company, *Venera* was less flustered by foreign imports. Indeed, it had always seen foreign companies as its primary competition, dismissing the few enterprises on the territory of the former Soviet Union that produced these items as hopelessly out-of-date stylistically.

Vis-à-vis contracts, *Venera* combined the behavior of *MBT* with an attitude that was superficially similar to *SK*. Its transactions were thoroughly documented by written contracts, yet these contracts turned out to be largely irrelevant to the ongoing interactions between *Venera* and its trading partners. Any sense of security that *Venera*'s management had in the reliability of its customers and suppliers was based more in personal trust than in the seemingly iron-clad guarantees contained in the contract. Contracts were viewed as a symbol of the commitment of the two parties to their joint enterprise. Once executed, however, they were filed away and rarely consulted.⁸⁹ When problems arose, *Venera*'s managers preferred to resolve it bilaterally through negotiations without using or even threatening to use legal remedies.

This basic attitude that strong relationships were more important than airtight written contracts was unwavering among *Venera*'s managers. It emanated from the top. The general director of *Venera* saw personal relationships as the key to stability. *Venera*'s sales directors⁹⁰ rarely took

⁸⁸ For most of the Soviet era, profiting from selling shortage goods at premium prices was considered speculation and was illegal. When cooperatives were legalized in the late 1980s, many of their proprietors (including the future general director of *Venera*) were able to find loopholes in the law that freed them to engage in such speculation. These sorts of activities help explain both the rapid increase in the number of cooperatives (from 8,000 in 1987 to 185,500 in 1990) and the general public's disaffection for them (only 14.7% of those surveyed in May 1990 had a positive attitude toward them). ANTHONY JONES & WILLIAM MOSKOFF, *KO-OPS: THE REBIRTH OF ENTREPRENEURSHIP IN THE SOVIET UNION* 16, 106 (1991).

⁸⁹ This mirrors the behavior observed by Macaulay in U.S. businesses. Macaulay, *supra* note 18, at 59.

⁹⁰ *Venera* had two assistant directors (*zamistitely direktora*) for sales. Their responsibilities were divided geographically. One concentrated on the European regions of Russia, while the other focused on Siberia and the Far East. The former had certain obligations in the realm of security. He visited prospective customers in order to evaluate

on new business without a preliminary face-to-face meeting during which they could evaluate the character of potential customers. Like their counterpart at *MBT*, these sales directors were skeptical about relying on documentary proof of customers' good standing, noting the ease of forgery. The sales department maintained detailed records of who paid when, and used them to determine the structure of future contracts, e.g. payment terms and penalties.

In the general director's initial forays into the lingerie market, he was like the proverbial over-friendly puppy—eager to be loved by all comers and assuming that any outward show of goodwill was genuine. In his first visits to trade shows he signed contracts indiscriminately. At the first trade show at which *Venera* had a booth to display its wares, he entered into forty contracts and, at the second, eighty. Though the behavior resembled that of *MBT*, the motivations and expectations of *Venera*'s managers reveal it to be different. To them, these contracts represented the start of beautiful friendships. The reality was, however, no different than at *MBT*. Relatively few of these putative contractual partners actually placed orders and even fewer lived up to their obligations to pay. The naïveté of the general director and the staff of the sales department was rooted in inexperience. Neither their short history working as independent brokers nor their much longer history working as engineers at state-owned defense plants gave *Venera*'s managers any appreciation of how difficult it could be to find reliable trading partners. At the third trade show, no contracts were signed. The general director and his staff understood that they needed to vet potential customers. At the fourth show, they entered into fifteen contracts and, at the fifth, forty-two. As this suggests, *Venera* took a different path from *MBT*. Rather than signing contracts first and asking questions later, *Venera*'s management reversed the process. Consequently, its files were not overflowing with fully executed but inoperative contracts but, instead, had a smaller number of contracts with engaged customers.

For the first few years, *Venera* maintained direct relationships with all of their customers. About two-thirds of its business was still being run on this basis in 1998. This was divided fairly evenly between spot sales made to anyone who showed up with sufficient cash at their production facilities on the outskirts of Ekaterinburg and shipments to retail outlets. As to the former, the fleeting nature of these transactions made contracts superfluous; a simple receipt was sufficient. Most of the customers were shuttle traders who cared little for legal formalities.⁹¹ The rapid turnover among these

their ability to pay and non-paying customers in order to “encourage” them to pay their debts to *Venera*.

⁹¹ Russians (usually women) who traveled long distances to buy items in bulk and returned home to sell them on the street or in flea markets were known as “shuttle traders” or *chelnoki*. Often they traveled abroad to seek goods, usually to countries that bordered Russia, such as China, Turkey, and Poland, but the phenomenon also occurred within Russia. See generally David Hoffman, *Russian Shuttle Traders Bear the Burdens of Capitalism*,

traders provided little incentive for *Venera's* managers to cultivate any sort of relationship. Indeed, uncertainty as to whether they would ever see a given trader again motivated their strict cash-only policy.

Another third of *Venera's* business revolved around retail outlets across Russia. For the most part, these relationships had begun at trade shows. All were grounded in written contracts. The source and content of the contracts depended on the market power of the customer. The yearning of vendors (including *Venera*) to sell their wares in the capital gave Moscow stores a virtual *carte blanche*. Of the twelve contracts *Venera* had signed with Moscow-based stores, all but one was based on the store's form contract rather than *Venera's*. By contrast, the ongoing contracts with retail outlets outside Moscow were, without exception, based on *Venera's* form sales contract.

A careful review of the Moscow contracts revealed the terms to be heavily weighted in favor of the stores. For example, several imposed an obligation on *Venera* to remove its lingerie promptly if it did not sell briskly enough or risk having a fine imposed.⁹² None contemplated penalties for failures by the stores to pay in a timely fashion. More telling was the language dealing with payment. Rather than being required to pay for the lingerie *Venera* shipped to them within a certain number of days, many of these stores paid only if and when the garments were actually sold.⁹³ Selling on such terms is regarded as degrading by Russian manufacturers, as evidenced by the *Venera* sales directors' vociferous denials that they ever engaged in these practices. The plain language of the Moscow contracts proved them wrong. To be fair, these top-of-the-line department stores did not bicker over contractual terms with vendors, regardless of whether they were wet behind the ears, like *Venera*, or household names. They offered their contracts on a take-it-or-leave-it basis. They understood both the allure and the financial currency of acceptance into this inner circle of retailing. Firms like *Venera* could use their presence on the racks of well-known Moscow stores to bully their way into smaller stores in the hinterland. Indeed, the *Venera* managers visibly puffed up with pride when talking about their success in Moscow, though they could still list stores in the capital that remained beyond their grasp.

Venera was more in the catbird seat when it came to stores outside

WASH. POST, Sept. 22, 1996, at A24.

⁹² One store required *Venera* to remove the offending items within three days of notification. If it failed to do so, the store was entitled to recover a fine equal to 0.1% of the value of the goods for each day *Venera* delayed. Other stores had analogous provisions. The contracts that were not on *Venera's* form were silent on the question of penalties for late payments (which was a standard clause in *Venera's* form contract).

⁹³ Of the twelve contracts *Venera* had with Moscow stores, nine (75%) required payment only after sales. Three called for payment to be made immediately upon sale, whereas the others gave the stores a grace period ranging from one month (four stores) to three months (two stores).

Moscow. To get a sense of the contrast, I reviewed the twenty-three contracts with retail outlets in the Far East. All were on *Venera's* two-page form contract. Like *MBT's* standard sales contract, *Venera's* contract was not designed to deal with a single sale, but to establish a regime to handle periodic sales over a year. It left the type of lingerie and the quantity to be fixed at the time of the sale by an attached order form. It left less leeway on prices. The parties agreed to be bound by *Venera's* price list at the time of shipment, which placed the entire risk of price increases on the customer. The only blanks left to be completed by the signatories dealt with the terms of payment. The sales department had to decide whether to ask for prepayment or whether to extend credit.⁹⁴ Its determination was based on the track record of the customer with *Venera* and its more general credit history as well as its relative market power. Basically, the sales department personnel had to weigh its desire for the business against the likelihood of getting paid. These contracts suggest that the size of the vendor plays a critical role in determining payment terms. Those doing business as individual entrepreneurs were uniformly required to pay for their goods up front. More well-established businesses were given greater leeway—typically they were required to pay within 20 days of delivery. Penalties for failure to pay were a standard feature of these contracts. The average amount was 0.2% per day of the amount owed, though it ranged from 0.1% to 0.5%. As this indicates, the simplicity of the document still left room for its terms to be subtly skewed in favor of *Venera*. Because *Venera* had less market clout than the Moscow department stores, it could not afford to be as heavy-handed. In addition to penalties, the contract included a forum clause that shifted jurisdiction to the local Ekaterinburg *arbitrazh* court in case of any dispute, thereby guaranteeing *Venera* “home court” advantage.⁹⁵ Though this was the provision most commonly challenged through “protocols of disagreement,” a majority of customers accepted it.

The sales department spent very little time negotiating with customers over contractual language. Its form contract had already been cut to the bare bones. If a customer objected to any of its provisions and put forward alternative language in the form of a protocol of disagreements, the sales department personnel uniformly acceded. Likewise they wasted no time quibbling with the Moscow department stores over the blatantly one-sided provisions in these stores' standard contracts. Their behavior reflects their blasé attitude toward contracts. Any confidence they had in the likelihood that their customers would pay on time stemmed from the personal trust

⁹⁴ Of these twenty-three contracts, eleven (48%) called for full prepayment, five (22%) provided for payment within twenty days, and the remaining seven (30%) had a variety of payment terms.

⁹⁵ If the parties do not otherwise agree in their contract, the law grants jurisdiction to the court closest to the defendant. *Arbitrazhnyi Protessual'nyi Kodeks [APK] [Code of Arbitration Procedure]* art. 25 (Russ.).

that had been built up over time. Written contracts were necessary to the trust-building process, but were far from sufficient. Likewise, other documentary evidence of goodwill, such as bank statements or tax records, was viewed with skepticism. Like their counterpart at *MBT*, the sales directors at *Venera* realized that any document could be forged and that relying exclusively on such evidence would be folly. Under these circumstances the customers' behavior took center stage. Not surprisingly, *Venera's* initial stance was to extend credit to no one. Its sliding scale for prepayment, starting with 100% for the first transaction and gradually decreasing to zero over the first year of the relationship, provided a critical test. As this practice became well known among retail outlets, some toed the line just long enough to get goods on credit and then absconded with them. To the sales directors, this simply reinforced their belief that relationships were the key to building a business.

When problems arose with customers, the sales department attempted to sort it out informally with the goal of reaching a mutually acceptable accommodation. Neither side relied on the contractual language during these negotiations, nor did lawyers conduct the negotiations. Occasionally *Venera* reminded delinquent customers of its right to pile on penalties if the debt was not paid, but it never actually went after penalties and the emptiness of the threat undercut its potency. Likewise, management made no secret of its distaste for litigation. It had initiated only one lawsuit in its relatively short history and the experience was disillusioning. They sued a store in Nizhny-Novgorod when all efforts to resolve the unpaid debt through negotiations proved unsuccessful. The court ruled in their favor, but when they went to collect on the judgment, they found the shelves stripped bare and the bank accounts empty. This undermined their already shaky confidence in the capacity of legal institutions and strengthened their resolve to rely on informal enforcement mechanisms. The general director and the sales directors made a point of getting to know their counterparts. The sales department kept careful records of their dealings. Particularly important in shaping *Venera's* attitude toward customers was the veracity of their managers.⁹⁶ The sales directors were willing to forgive equivocation by low-level personnel, especially if it was not actually false at the moment. For example, they saw a qualitative difference between the following two scenarios that might occur after payment has come due. First, a customer representative calls and explains that the customer was experiencing financial difficulties but plans to pay the amount owed in ten days. The payment is, in fact, not made in ten days. Second, a customer representative calls and expresses surprise that *Venera* has not received

⁹⁶ Along similar lines, Macaulay reports that, rather than placing total reliance on written contracts, U.S. “[b]usinessmen often prefer to rely on ‘a man’s word’ in a brief letter, a handshake, or ‘common honesty and decency’—even when the transaction involves exposure to serious risks.” Macaulay, *supra* note 18, at 58.

payment, telling them that the bank had been instructed to make payment. It later comes to light that no such instructions were ever given. According to the sales director, while the first untruth was forgivable; the second was not. Their willingness to tolerate lies dissipated as the place of the liar rose in the firm hierarchy. Lies of any sort from a customer's general director were considered beyond the pale and constituted grounds for immediate termination of the relationship. They saw such behavior as a sign of disrespect to *Venera* and a harbinger of worse things to come.

Not surprisingly, the sales department personnel grew weary of the never-ending chore of assessing the creditworthiness of customers. Just like their counterparts at *MBT*, they worked assiduously at gathering information about the credit practices of prospective and ongoing customers but found themselves in the position of a modern-day Diogenes, *i.e.*, on a constant and mostly frustrating search for honest firms. Both of these enterprises sold their output primarily to retail stores which, during the 1990's, was a chaotic market in Russia. Stores and kiosks tended to be poorly capitalized, and their proprietorship turned over with startling frequency. Despite their best efforts, the vetting process remained somewhat haphazard and was far from foolproof. Arrears mounted quickly and usually had to be written off. Unlike their counterparts at *MBT*, who accepted such problems as a cost of doing business, *Venera's* management took steps to reduce these transaction costs.

The general director decided to transition to a system of regionally-based dealers. The sales department had agitated for this move, arguing that its personnel were spending too much time verifying the creditworthiness of the constantly changing pool of customers. Under the new system, the burden of ensuring that the customer will pay in a timely fashion was shouldered by the dealer (rather than *Venera*). Because the dealers were geographically closer to the stores and more tied into the local community, they were better able to assess reliability. This network of dealers could not, of course, be built overnight. Initially, the general director concentrated his efforts in the non-European regions of Russia, east of the Ural Mountains, where the competition for his lingerie was weakest. He started slowly, beginning in 1993 with just one dealer in Novosibirsk. By mid-1998, *Venera* had eight dealers and sales through its dealers accounted for approximately 30% of annual revenues. All of these dealers had been hand-picked by the general director; he knew them personally and believed them to be trustworthy. He took comfort in the fact that, in his words, *Venera* and the dealers had "grown up together." Even so, he and the sales department personnel understood that authorizing these dealers to act as *Venera's* agents was far from risk-free. Hundreds, sometimes thousands of miles, separated them, and they could not be sure how hard the dealers were trying to sell *Venera's* output. The contracts between *Venera* and its dealers were simple—consisting of just a few pages—and set the basic terms of trade. In essence, the dealers bought *Venera's*

undergarments in bulk, entitling them to price concessions, and endeavored to resell them through retail outlets in their locale.⁹⁷ As a rule, payment was due fifty business days after receipt, which was more than twice the leeway granted to most retail outlets with which *Venera* had individual contracts. Each dealer held an exclusive right to sell *Venera*'s lingerie in a specified geographic region and agreed to sell only the *Venera* brand of lingerie.⁹⁸ *Venera* did not compensate the dealers directly. Instead, the dealers' remuneration came from the mark-ups they placed on the lingerie when they resold it. The contracts were silent on this issue and thus imposed no limits on the amounts that could be charged. The sales department left this to be governed by the market, reasoning that if the mark-ups became exorbitant, sales would suffer and the dealer would lower its price. Dealers placed orders on a quarterly basis, which provided enough lead-time to allow demand to be met. The precise quantities were not specified in the contract, but were communicated through faxed orders.⁹⁹ In the early years, the contracts itemized what the dealers would buy during the upcoming year. This system was found to be too inflexible to accommodate the vagaries of consumers in a market environment and was abandoned.

Though the dealers' contracts began as a form contract developed by *Venera*, each was carefully modified to suit the specific situation of a single dealer. On its face, this would seem to indicate that the contracts were meaningful. The inclusion of penalties for non-performance provides further supporting evidence. In addition to the standard clause imposing penalties for late payment,¹⁰⁰ these contracts also allowed *Venera* to terminate the contract unilaterally if a dealer's orders dropped below a predetermined amount. This latter provision was not in the original form document. It had been added at the insistence of the chief financial officer. Upon her arrival in 1997, she was astonished to discover that *Venera* had no way to extricate itself if a dealer's sales declined. The inclusion of such a mechanism had already proved its merit on one occasion. Though *Venera*

⁹⁷ Price concessions were negotiated on case-by-case basis. The Omsk dealer got a 25% discount if it bought more than 75 million rubles of *Venera*'s products; others only got a discount if they prepaid. *Venera* was keen for prepayment but recognized that its market position was not strong enough to allow them to demand it. Consequently, it created positive incentives to encourage prepayment by its dealers.

⁹⁸ The contract with the dealer based in Khabarovsk lacked the exclusivity clause that was present in the other dealer contracts. At the time of my field research, it had just been added to *Venera*'s network. According to one of the sales directors, the two were still working out the terms of their relationship. Until both were certain of the viability of the partnership, *Venera*'s management felt it would be unfair to limit the dealer from pursuing other opportunities.

⁹⁹ As compared to *MBT*, the system *Venera* constructed was a more genuine "blanket order" system. See also *supra* note 56.

¹⁰⁰ Most of the dealer contracts called for penalties of 0.1% per day on the unpaid balance, which was significantly less than the typical rate of 0.5% imposed by most Russian manufacturers.

ultimately decided not to walk away, the availability of termination as a legal option gave it leverage when negotiating with the under-performing dealer. My conversations with the general director revealed this reliance on contractual language to be an aberration,¹⁰¹ though he professed an ambition to make this behavior the norm. I was uncertain of how genuine his commitment was to this goal of enforcing contracts. It seemed to me that he was putting on a good face for the foreign law professor, *i.e.*, trying to impress me by appearing to be dedicated to contractual compliance. My skepticism was confirmed by the lack of awareness of the sales department personnel of this paradigm shift. Questions to the sales directors about the specifics of these contracts were typically greeted with stares of incomprehension. When I showed them the contracts, thereby reminding them of their terms, they could often reconstruct the reasoning behind the content. But it was painfully evident that these operation-level managers had not looked at, or thought seriously about, these contracts after signing them. Rather than relying on the contract and the capacity of the courts to enforce it, they preferred to rely on the strength of the relationship they had built (or were building) with their dealers to guarantee mutual performance.

VI. EXPLAINING THE RELUCTANCE OF RUSSIAN MANAGERS TO RELY ON CONTRACTS

A. The Worldview of Firm Management

In many ways, *Venera* and *MBT* were similarly situated. Both produced goods to be sold to the public through retail outlets owned by others. Both had to cope with rapid turnover in the retail sector in the late 1990s and with a business climate in which economic actors were less than forthcoming about their financial wherewithal. Yet their strategies vis-à-vis contracts were remarkably different. *Venera's* management team prided itself on having close personal ties with its dealers and retail customers. They went through the ritual of negotiating and signing written contracts, but saw it as part of the bonding process, rather than as a way of protecting themselves legally. The negotiations allowed them to take the measure of prospective customers. Their goal was a contractual regime in which the

¹⁰¹ Macaulay's work shows that a distaste for resorting to the language of the contract is not unique to Russian managers. Writing about U.S. managers, he notes:

Disputes are frequently settled without reference to the contract or potential or actual legal sanctions. There is a hesitancy to speak of legal rights or to threaten to sue in these negotiations. Even where the parties have a detailed and carefully planned agreement which indicates what is to happen if, say, the seller fails to deliver on time, often they will never refer to the agreement but will negotiate a solution when the problem arises apparently as if there had never been any original contract. Macaulay, *supra* note 18, at 61.

language of the written contract was irrelevant because the norm of on-time payment had been woven into the relationships with the customers and violating that norm would be morally unacceptable to the customers. By adopting this strategy, *Venera's* managers betrayed an optimism about human nature that was unusual among Russian managers in the late 1990s. Perhaps their shorter track record and their good fortune since starting the company allowed them to count on the best in others.

By contrast, cynicism was the watchword at *MBT*. The difference in the worldviews of the sales directors of the two companies was apparent from the survey. When asked whether people are basically trustworthy on a scale from zero (completely untrustworthy) to ten (completely trustworthy), the *MBT* sales director's score of three revealed her skeptical nature, whereas the *Venera* sales director was characteristically sanguine with a score of ten. To be fair, *MBT's* sales director had been put through the ringer. When I encountered her in early 1998, she was at her wit's end. She felt that she had done everything possible to ensure that *MBT's* customer base was uniformly financially sound, yet her efforts were somehow never enough. Whether the customers that defaulted were unprincipled or merely desperate is unclear, but that distinction was unimportant from *MBT's* point of view. The result was the same: *MBT* was plagued with customers that could not or would not live up to their contractual obligations. Unlike *Venera*, *MBT* did not respond by redoubling its efforts to establish personal trust with its customers. Just the opposite; *MBT's* sales director openly abandoned any pretense of relying on the bonds of friendship and gave herself over to calculative trust. In her words: "friendship is friendship, but work is work." Consequently she placed more faith in the written contracts themselves and, irrespective of personal ties, pursued recalcitrant customers to the full extent of the law, though she opted for litigation only when brass-knuckle negotiations failed.

SK shared the desperation of *MBT's* customers. Its management was willing to do whatever it took to survive, but still wanted to put up a good front. This attitude contributed to the bizarre situation where elaborately negotiated written contracts languished unused while the real business took place without the benefit of formal written contracts.

B. Sectoral Uncertainty

Though *SK's* management may have exacerbated its situation through poor decisions, its willingness to trust its trading partners was beside the point. Its options were constrained by its place in the production chain and its sectoral identity. The entire auto industry, of which *SK* was a part, suffered due to Russia's economic depression during the 1990s. The lack of sales led to a lack of money which, in turn, led to barter transactions. These barter transactions did not lend themselves to written contracts. Even when integrated into complicated chains of mutually reinforcing exchanges, the individual transactions were straightforward in-kind exchanges. There

were no lingering questions of credit; there was no need to debate what sort of penalties would be imposed for non-payment. Indeed, non-payment was not possible for barter transactions. If one side backed out, then the exchange was abandoned with no damages accruing to either side.

The retail sector was much healthier. More importantly, sales were made for cash, not as in-kind exchanges. This meant that producers had to work out terms for payment. The highly competitive nature of the retail sector gave power to customers. Producers could rarely demand cash up front. Instead, they had to work out credit arrangements, which gave rise to uncertainty in terms of repayment. In this context, written contracts were useful, perhaps even necessary. This explains why both *MBT* and *Venera* routinely concluded written contracts with their customers, even if both regarded legalistic remedies as a last resort, preferring to resolve problems through negotiation.

C. The Weakness of the Legal Infrastructure

The three patterns of behavior uncovered in the case studies are unified by a reluctance to rely primarily on contracts. The reasons for, and extent of, this hesitancy vary, but the bottom line is the same. A number of scholars have argued that the attitudes and behavior exhibited by Russian managers during the 1990s was a direct consequence of the shortcomings in the substantive law and the courts empowered to enforce it.¹⁰² There is no question that the inadequacies of the legal infrastructure—both real and perceived—are part of the explanation. But it does not account for the variants in behavior uncovered through the case studies. To be sure, *Venera's* difficulties in getting its judgment against a retailer enforced soured it on *arbitrazh* courts,¹⁰³ but *MBT* was a frequent and enthusiastic litigant. Our survey suggests that *MBT* was more typical; an astonishing 80% of the enterprises surveyed had been a party to an *arbitrazh* court case between 1995 and 1997.¹⁰⁴ Buttressing our findings are the official caseload statistics, which show a 31% increase in cases decided by the *arbitrazh* courts between 1993 and 1998.¹⁰⁵

¹⁰² See e.g., Hay et al., *supra* note 6; Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911 (1996).

¹⁰³ Unlike *MBT* and *SK*, *Venera* did not have an in-house lawyer. After *Venera* prevailed in its case, the manager handling the case erred in filling out the form (*ispolnitel'nyi list*) required to seize the proceeds of the store's bank account. The error was easily fixed, but by the time the new document was prepared, the defendant had emptied its bank accounts, rendering itself virtually judgment proof. This was a mistake that the experienced *MBT* lawyer would not have made. *Venera's* reaction—avoiding the courts—was perhaps overkill. For a fuller discussion of this incident, see Hendley, *In-House Counsel*, *supra* note 3.

¹⁰⁴ Hendley et al., *supra* note 10, at 853.

¹⁰⁵ Compare *Sudebno-arbitrazhnaia statistika: O rabote arbitrazhnykh sudov Rossiiskoi Federatsii v 1992-94 godakh*, Vestnik Vysshego Arbitrazhnogo Suda [Judicial-Arbitrazh

At the same time, the case studies reveal a common fear that trading partners would not live up to their contractual obligations. Policy makers could have done nothing, trusting in the power of market incentives to persuade economic actors to live up to their agreements. But Russian officials took a different path. In May 1992, a presidential decree authorized the imposition of penalties for delinquent payments for goods and services in the amount of 0.5% per day of the amount of the outstanding debt.¹⁰⁶ The hope was that these hefty penalties would deter non-payments. At the same time, penalties were not made mandatory, but were left to the discretion of the party harmed by the breach. The decree constrained the parties' freedom to the extent that it limited the penalty rate that could be imposed.

The Civil Code, passed in 1994, reflected this same approach by endorsing the use of penalties for breaches of contract.¹⁰⁷ Honoring the principle of freedom of contract, the Code did not quantify the rate at which penalties could be assessed but left that decision to the contractual parties. The Code included several sections that, taken together, had a somewhat perverse effect. For example, it incorporated a three-year statute of limitations for contractual claims, and imposed no affirmative duty to mitigate damages.¹⁰⁸ Therefore, parties could pad their claims by waiting until the last moment to file.¹⁰⁹ In addition, the Civil Code allowed claims for interest as part of non-payment claims.¹¹⁰ The purpose was to ensure

Statistics: On the Work of the Arbitrazh Courts of the Russian Federation in 1992-1994, Bulletin of the Higher Arbitrazh Court], 1995 No. 4 [monthly], at 75; with *Osnovnye pokazateli raboty arbitrazhnykh sudov Rossiiskoi Federatsii v 1998-1999 godakh*, Vestnik Vysshego Arbitrazhnogo Suda [Judicial-Arbitrazh Statistics: The Main Indicators of the Work of the Arbitrazh Courts of the Russian Federation in 1998-1999, Bulletin of the Higher Arbitrazh Court], 2000, No. 4 [monthly], at 6.

¹⁰⁶ Postanovlenie Prezidiuma Verkhovnogo Soveta Rossiiskoi Federatsii i Pravitel'stva RF "O neotlozhnykh merakh po uluchsheniiu raschetov v narodnom khozyaistve i povyshenii otvetstvennosti predpriyatii za ikh finansovoe sostoianie." *Vedomosti S'ezda narodnykh deputatov i Verkhovnogo Soveta RSFSR* [Decree of the Presidium of the Supreme Soviet of the Russian Federation and Government of the RF "Regarding Urgent Guidelines for Improving Accounting and Increasing the Responsibility of Enterprises for Their Financial Condition." Gazette of the Congress of People's Deputies and Supreme Soviet of the RSFSR], no. 23, item 1252, May 25, 1992.

¹⁰⁷ Civil Code arts. 329-32.

¹⁰⁸ Civil Code art. 196.

¹⁰⁹ Typically this happened when the creditor firm had no realistic hope of collecting. The creditor would nonetheless file a lawsuit claiming the original debt plus the accrued penalties. If the debtor firm had no assets, it would not bother to defend the case. The *arbitrazh* court would enter a judgment for the full amount, which the creditor firm could use to offset any profits and reduce its tax liability. The tax authorities took court judgments as convincing evidence of the existence of the debt. The out-of-pocket costs to the creditor firm for obtaining the judgment were minimal. See generally, Kathryn Hendley, *Business Litigation in the Transition: A Portrait of Debt Collection in Russia*, 38 LAW & SOC'Y REV. 305 (2004).

¹¹⁰ Civil Code art. 395.

that the “victims” of breaches did not suffer doubly due to inflation. The interest rate was pegged to the discount rate of the Russian Central Bank.

Russian economic actors embraced penalties enthusiastically and quickly, which undermines the common wisdom that businessmen paid no attention to law. In my review of hundreds of *arbitrazh* court files in Moscow, Saratov, and Ekaterinburg from 1993 to 1997, the increased use of penalty clauses to punish late payment stood out.¹¹¹ Moreover, the enterprises surveyed in 1997 reported that more than half of all sales contracts include penalty clauses.¹¹² Yet the success or failure of the policy should not be judged in terms of how often penalty clauses were included or even how often penalties were collected. The original policy goal was to enhance contractual discipline and, judged in those terms, penalties failed miserably. Not only did the non-payments problem persist, but penalties arguably made matters worse by adding to the mountain of debt carried by many enterprises. Penalties were often forgiven in the final analysis, but until then, they weighed down the enterprise since penalties can be included in the overall debt reflected in bank records.¹¹³ This, in turn, limited the enterprise’s ability to attract outside investment and to carry on ordinary business.

One reason why penalties proved counter-productive in the Russian setting was their sheer size. The rate was purposely set high to act as a negative reinforcement. That, combined with the three-year statute of limitations and the absence of any duty to mitigate damages, has created an untenable situation. All too often, the penalties awarded exceeded the original debt.¹¹⁴ The absurdity of the situation was not lost on either the participants or the courts. After all, there was little hope that the losing defendants would be able to pay these judgments. Yet the debt (including the penalty) would be attached to their bank accounts. Rather than pushing such enterprises into bankruptcy—as Western advisers might have predicted—managers worked to avoid having any of their income stream pass through their bank accounts.¹¹⁵ This, of course, served no one’s

¹¹¹ See generally Kathryn Hendley, *Growing Pains: Balancing Justice & Efficiency in the Russian Economic Courts*, 12 TEMP. INT’L & COMP. L.J. 302, 319–26 (1998).

¹¹² Hendley et al., *supra* note 10, at 636.

¹¹³ Bank regulations prevailing in the 1990s required banks to keep account of all outstanding debts of a firm, including debts to other firms and to the state in the form of tax arrears. Any revenue that came into a debtor firm’s account would then automatically be applied to draw down this debt. For more on how this system worked, see generally Kathryn Hendley, *Payments Problems*, *supra* note 3.

¹¹⁴ See e.g., Hendley, *supra* note 111, at 324.

¹¹⁵ The bankruptcy code adopted in 1998 facilitated bankruptcies. See generally William P. Kratzke, *Russia’s Intractable Economic Problems and the Next Steps in Legal Reform: Bankruptcy and the De-politicization of Business*, 21 NW. J. INT’L L. & BUS. 1, 33–50 (2000). As the Yukos case demonstrated, the Kremlin can use the bankruptcy laws as a potent weapon. Erin A. Arvedlund & C.J. Chivers, *As Deadline Nears, Yukos Faces a \$3.4 Billion Tax Bill*, N.Y. TIMES, July 7, 2004, at C6.

interests.

Beginning in 1997, the situation began to change. Encouraged by an “Informational Letter” from the Higher *Arbitrazh* Court, trial court judges began to reduce penalties.¹¹⁶ The Court found the authority to do so in a section of the Civil Code that disallowed penalties that were “clearly disproportional.”¹¹⁷ Gradually, this concretized into a rule that penalties in excess of the debt were forbidden.¹¹⁸ The courts also closed the door on going after both penalties and interest, characterizing it as double-dipping. Plaintiffs had to elect either compensatory (interest) or punitive (penalties) damages.

The story of how the mechanism for dealing with non-payments evolved during the 1990s illuminates how different elements of the state contributed to the process. In the early days, the executive branch came up with an admittedly temporary solution that was made redundant by the passage of the Civil Code in 1994. But when it became clear to judges that the solution (penalties) was actually making the problem worse, they found a way out by using a throw-away provision of the Civil Code creatively. Sadly, what was still missing from the picture was a sense of societal responsibility. Enterprises that were deep in debt seemed to feel no shame, nor were they shunned. Reputational sanctions remained weak. This continues to be a missing link that threatens to undermine the system.

D. The Weakness of Reputational Sanctions

Law works best when treated as a safety net. It can police those who deviate from societal norms, but cannot serve as the solitary bulwark against unscrupulousness. This is a universal reality. Macaulay argues that the norm that “one does not welsh on a deal” is more powerful than the

¹¹⁶ “Informational Letters” are mechanisms by which the Higher *Arbitrazh* Court conveys its thoughts on a particular issue to lower courts. They are generally issued when the top court wants to signal a shift in interpretation. Technically they have only persuasive authority. In practice, however, they are regarded as binding authority. In this case, the “Informational Letter” was attached to a summary of judicial practice related to the reduction of penalties by the courts under Article 333 of the Civil Code. “Informatsionnoe pis'mo,” no. 17, July 14, 1997, *Vestnik Vysshogo Arbitrazhnogo Suda* [“Informational Letter,” no. 17, July 14, 1997, *Bulletin of the Higher Arbitrazh Court*], 1997, No. 9 [monthly], at 75–80.

¹¹⁷ Civil Code art. 333. Russia has a civil law legal heritage and, therefore, its courts’ judgments have traditionally not been treated as precedent. In recent years, this has begun to change. For a survey of the relevant literature, see S.K. Zagainova, *O pretседentno-pravoprimenitel'noi prirode sudebnykh aktov v grazhdanskom i arbitrazhnom protsesse*, *Gosudarstvo i pravo* [On the Precedent-Rulemaking Nature of Judicial Acts in the Civil and Arbitrazh Process, State and Law], 2009, no. 10, at 19–20.

¹¹⁸ See generally Kathryn Hendley, Peter Murrell & Randi Ryterman, *Punitive Damages for Contractual Breaches in Comparative Perspective: The Use of Penalties by Russian Enterprises*, 2001 *Wis. L. Rev.* 639 (2001).

dictates of the law in ensuring contractual discipline in the U.S. case.¹¹⁹ Along similar lines, McMillan and Woodruff cite examples ranging from Shasta County ranchers to 19th century Mexican merchants to contemporary Vietnamese businessmen to support their thesis that when “interactions are frequent and residents expect them to continue indefinitely into the future,” concerns over the damage to their reputation that would accompany a contractual breach would ensure compliance.¹²⁰ They underscore the power of gossip networks in maintaining cooperative relations and keeping businessmen honest.

At first glance, the situation in Russia in the late 1990s would seem to be ripe for the inculcation of such norms of cooperation. After all, many firms had stuck by their Soviet-era trading partners, even after they were freed to explore other options. It would be a mistake, however, to view the enterprises that had worked together during the decades of Soviet power as communities, with self-enforcing norms of behavior. A community assumes the free exchange of information. In Soviet trading networks, participants knew only the firms to which they had been linked by their industrial ministries. Information was closely guarded. There was no tradition of the free exchange of information that undergirds a gossip network that might put out the word that one or another manager was not to be trusted. Indeed, informal sanctions had no place in a planned economy. They are aimed at identifying bad actors, with the ultimate goal of ostracizing such bad actors from the network. This, in turn, assumes that firm-level managers are able to pick and choose among a wide variety of trading partners. It further assumes that exit is an option. Neither was true for a planned economy.

As state price controls were lifted and the machinery of state planning was discarded in early 1992, firm managers seemed to have almost limitless opportunities. In reality, they continued to be constrained by the muted flow of information. In a world where marketing and advertising were in their infancy and where the idea that sharing information could be beneficial was considered odd, Russian managers actually had very little flexibility. They stuck by old trading partners, rarely out of any sense of community or personal loyalty, but mostly out of desperation. As inter-enterprise debt mounted, their desperation grew deeper. The options open to Russian managers were limited and unenviable. They could continue to throw good money after bad by working with their traditional partners, many of whom had proven to be unwilling or incapable of living up to their

¹¹⁹ Macaulay, *supra* note 18, at 63.

¹²⁰ McMillan & Woodruff, *supra* note 32, at 2432–33. *See also* Barak D. Richman, *How Community Institutions Create Economic Advantage: Jewish Diamond Merchants in New York*, 31 *LAW & SOC. INQUIRY* 383 (2006). *See also* Macaulay, *supra* note 18, at 63 (emphasizing the importance of the expectation of continuing relations to ensuring contractual discipline).

contractual obligations. Alternatively, they could seek out new trading partners, but without any way to reliably assess their credit-worthiness. Put bluntly, familiar trading partners were the devil they knew. Sometimes, these known devils went too far and were tossed aside. *SK*, which had become a pariah due to its inability to pay its suppliers, is a good example. But the decision to fire *SK* as a customer was made on a bilateral basis by each of its suppliers. It was not a sanction for violating community norms.

More generally, even though many firms, in fact, engaged in repeated transactions, they had no sustained expectation of repeated interactions. They were always waiting for the proverbial shoe to drop. In practical terms, this meant that they gained few of the benefits that typically inure under such conditions.¹²¹ Bilateral informal norms of self-enforcement were slow to evolve. Community norms of the sort that Lisa Bernstein¹²² and Barak Richman¹²³ uncovered in the diamond trade were scarcer. For the Russian managers I studied, every deal was a new battle to be fought.

At the heart of the dilemma facing Russian managers in the late 1990s was the absence of a general consensus that one does not welsh on a deal. Its absence was yet another legacy of the Soviet era. Trained under state socialism, managers were never forced to balance their books. Efforts to shift enterprises over to self-sufficiency had begun under Gorbachev's *perestroika* in the mid-1990s, but proceeded slowly.¹²⁴ Unwilling to risk the social unrest that might come with bankruptcies and labor dislocations, the state continued to bailout firms out under Gorbachev. Though some subsidies persisted under Yeltsin, firms were mostly left on their own. As inter-enterprise debt spread throughout the economy, it became an accepted fact of life for industrial enterprises, not an embarrassment. Perhaps it failed to be perceived negatively because Russians did not make the link between debt and fault. Certainly they did not see debt as an indicator of moral depravity. It was often impossible to pinpoint the culprits. Even firms that were determined to live up to their obligations stumbled when their customers failed to pay. One after another, firms fell like dominos. A conversation I had with a Russian businessman in the corridors of the Moscow City *Arbitrazh* Court in 1997 is illustrative. He asked how the United States handled its non-payments problem. I told him that the United States did not really have a non-payments problem. He was amazed and asked how this could be possible. I explained the concept of reputational sanctions, telling him that anyone who regularly welshed on their debts

¹²¹ See Simon Deakin, Christel Lanen & Frank Wilkinson, *Trust or Law? Towards an Integrated Theory of Contractual Relations between Firms*, 21 *J.L. & Soc'y* 329, 334–40 (1994).

¹²² Lisa Bernstein, *Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry*, 21 *J. LEGAL STUD.* 115 (1992).

¹²³ Richman, *supra* note 119.

¹²⁴ See generally Hewett, *supra* note 42, at 322–33.

would be ostracized. He laughed and told me that any businessman who paid his debts on time would be regarded as a fool in Russia. This anecdote shows the extent to which not paying one's debts had become routine. It follows that if debt is not demonized, then the societal commitment to not welfsh is going to be shallow.

Those of us socialized from birth in a well-established market environment might wonder why Russian managers of the late 1990s failed to demand some more effective mechanism for assessing prospective customers' credit-worthiness. Leaving aside the obvious collective action problem that arises in a country as thoroughly atomized as the former Soviet Union, one cannot demand what one does not know exists. This is the familiar problem of bounded rationality.¹²⁵ Most Russian managers either came of age under state socialism or were trained by others who did. They were taught how to cajole shortage goods out of reluctant suppliers. They learned how a strong personal relationship with key managers could help ensure that they received much-needed inputs in a timely fashion, thereby allowing them to meet the production targets for their enterprise. When market reforms came, they adapted these skills to the new conditions. For those who continued to deal with the same trading partners, much of what they had learned was transferable. To be sure, they were no longer trying to pry loose deficit goods. Instead, their task was to convince cash-strapped customers to pay them instead of the many other creditors pleading to be paid.

The sort of personal trust managers had been taught to cultivate in their partners worked to good effect. This strategy was less successful when dealing with unfamiliar firms. Indeed, often it worked to their detriment by encouraging managers to make decisions based on their gut instinct as to the trustworthiness of the firm representatives they met. In the absence of a preexisting relationship, these representatives often lied. As managers recognized the futility of relying on outward appearances of reliability, they sought out more objective indicators, such as bank statements. But these documents were typically provided by the prospective customers, illustrating that they remained locked into the bilateral framework that had served them well in the past. Nothing in their

¹²⁵ See generally Matthias Klaes & Esther-Mirjam Sent, *A Conceptual History of the Emergence of Bounded Rationality*, 37 HIST. OF POL. ECON. 27 (2005). Zucker's twist on this concept may also be applicable. She writes:

While rationality is bounded because of imperfect information, efficiency is bounded because payoff to innovativeness is uncertain, and because transactions require willing exchange partners, based on perceptions of legitimacy, similarity, and common interests. The end result is bounded efficiency, where a firm is pressured to perform w/in limits set by the high and low performers in the relevant comparison group. Zucker, *supra* note 28, at 67.

prior experience would lead them to look to third parties for assessments of trustworthiness. Just the opposite. Thus, the idea of relying on a credit-rating agency would not have resonated with them.¹²⁶

E. Inertia

As this suggests, the managers at the case study enterprises often behaved in a rote manner, replicating the behavior that had served them well in the past. The lack of stability within the Russian economy in the late 1990s left little time for reflection. Managers behaved instinctually, drawing on habits formed during the Soviet period. The role of inertia is often underappreciated, but cannot be overlooked in explaining behavior during economic transitions.

The explanatory power of inertia is particularly evident with regard to *MBT* and *SK*, the two case studies that shared a lengthy Soviet history. *MBT*'s use of the "protocols of disagreement" made no logical sense once central planning ended. *MBT* had already taken the first step by creating its own form sales contract in lieu of the form previously mandated by its industrial ministry. Yet the next step of making the few quick adjustments to the form that would be needed for each specific transaction eluded them. Neither the in-house lawyer nor the sales director could give me a reason for this. It was apparent that the idea of not using the protocols had never occurred to them. After all, protocols did not cause any harm; they simply made the transaction more cumbersome. Streamlining the contractual process fell rather low on the list of priorities for *MBT*'s lawyer and sales director.

The pull of inertia had created a sort of parallel universe at *SK* in which *SK* continued to behave as if it were supplying the auto, truck, and aviation assembly plants that had been its key customers in the Soviet era. Managers at *SK* and at these former customers colluded to sustain this fantasy. They spent considerable time working through each others' proposals for amendments to the contracts. Not surprisingly they (like *MBT*) used "protocols of disagreement" to communicate their desired changes. The only possible economic justification for this behavior was a hope that production would be revived at these assembly plants. By 1998—five years into Russia's economic depression—it would be more accurate to characterize this as a fantasy rather than a hope. But it was easier for the *SK* managers to replicate past behavior than to face the difficult truth that life had changed for good.

¹²⁶ On the rise of credit-rating agencies in the United States, see generally, J. Wilson Newman, *Dun & Bradstreet: For the Promotion and Protection of Trade*, in REPUTATION: STUDIES IN THE VOLUNTARY ELICITATION OF GOOD CONDUCT 85 (Daniel B. Klein ed., 1997).

VII. CONCLUSION

While my research confirms the common wisdom that contracts played a marginal role in Russian business life of the late 1990s, it strongly suggests that the reasons for this had little to do with the inadequacies of contract law or fears of being unable to enforce court judgments. For Russian managers, these were second-order issues. Their main preoccupation was with figuring out the credit-worthiness of potential trading partners. They had few institutional tools to help them assess reputation. There were no credit-rating agencies; firms lacked lengthy track records. Managers knew that if they mistakenly extended credit to a scoundrel firm, the firm would have made itself effectively judgment-proof either by emptying out its bank accounts or by disappearing into thin air. Even the best legal system can do little to protect against this sort of “anything goes” business culture. In such a race to the bottom, worrying about the law was akin to rearranging the deck chairs on the Titanic.