

CONTRACT ENFORCEMENT
IN POST-SOVIET UKRAINIAN BUSINESS

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ABSTRACT

CONTRACT ENFORCEMENT IN POST-SOVIET UKRAINIAN BUSINESS

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Using the findings of a five-year ethnographic study, this thesis examines the contractual relationships that prevail in low-technology moderately competitive industries characteristic of the contemporary Ukrainian economy. The research reports on how contracts are enforced and how the stability of business relationships is ensured in Ukraine.

The established view of many scholars that business efficiency is held back in most post-Soviet economies by frequent contractual violations and dysfunctional courts is not entirely supported by the research underpinning this thesis: in Ukraine, contract enforcement is generally effective enough to allow stability in day-to-day transactions, and the commercial courts do provide adequate backing.

Although the mechanisms used to enforce contracts in Ukraine are generally similar to those found in developed countries, there are distinctive features within the overall pattern. In particular, firms rely extensively on repeated interactions and self-enforcing devices while signing short-term formal contracts and avoiding interdependency between trading partners. They do not rely on their reputation or business association memberships and they make no use of private arbitration. Instead, a few legal institutions dating back to the Soviet period proved adaptable and viable in a market economy.

When transactions involve either state-owned companies or the exercise of administrative resources, contract enforcement becomes problematic. Illegal kickbacks from suppliers and the coercive use of state machinery come into play, and asking a court to enforce a contract is more costly and less effective than in other cases. However, the author shows that in the typical everyday transactions of Ukrainian private firms, the state and its administrative resources are involved in the minority of cases, and that they do not undermine the dominant pattern of orderly contractual dealings.

The thesis concludes that the contractual pattern prevalent in Ukraine effectively serves straightforward traditional buyer-seller transactions but it is ill-suited to meet the requirements of globalized trade, production diversification and technological progress. Adaptations of the existing system to meet these requirements are likely to depend upon changes in the wider business environment, namely upon institutions constraining the coercive power of the state.

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TRANSLITERATION TABLE FOR RUSSIAN LANGUAGE

BGN/PCGN 1947

	Russian		Romanization
1.	А	а	a
2.	Б	б	b
3.	В	в	v
4.	Г	г	g
5.	Д	д	d
6.	Е	е	e, ye ¹
7.	Ё	ё	ë, yë ²
8.	Ж	ж	zh
9.	З	з	z
10.	И	и	i
11.	Й	й	y
12.	К	к	k
13.	Л	л	l
14.	М	м	m
15.	Н	н	n
16.	О	о	o
17.	П	п	p

	Russian		Romanization
18.	Р	р	r
19.	С	с	s
20.	Т	т	t
21.	У	у	u
22.	Ф	ф	f
23.	Х	х	kh
24.	Ц	ц	ts
25.	Ч	ч	ch
26.	Ш	ш	sh
27.	Щ	щ	shch
28.	Ъ	ъ	”
29.	Ы	ы	y
30.	Ь	ь	’
31.	Э	э	e
32.	Ю	ю	yu
33.	Я	я	ya

NOTES

1. The character e should be romanized **ye** initially, after the vowel characters а, е, ё, и, о, у, ы, э, ю, and я, and after й, ъ, and ь. In all other instances, it should be romanized **e**.

2. The character ë is not considered a separate character of the Russian alphabet and the dieresis is generally not shown. When the dieresis is shown, the character should be romanized **yë** initially, after the vowel characters а, е, ё, и, о, у, ы, э, ю, and я, and after й, ъ, and ь. In all other instances, it should be romanized **ë**. When the dieresis is not shown, the character may still be romanized in the preceding manner or, alternatively, in accordance with note 1.

3. Unusual Russian character sequences occurring primarily in non-Russian-language names may be romanized as shown below in order to provide differentiation from regularly-occurring digraphs and character sequences.

Russian	Romanization
й before а, у, ы, or э	y
ы before а, у, ы, or э	y
ы after any vowel character	y
э after any consonant character except й	e

PART I INTRODUCTION

Ukraine, as one of the post-Soviet countries undergoing a transition from a planned to a market economy, is renowned for its extreme political and economic instability, including its democratic break-through and immediate retreat. Despite the grim view of post-Soviet business produced by earlier research on transition, the Ukrainian economy has exhibited substantial growth in recent decade. This raises a number of questions, such as: How are contracts enforced in profoundly uncertain environment to allow economy to grow? How do businesses adapt to this environment, cooperate with each other and contribute into the country's economy?

Inspired by these questions the Introduction presents the puzzle and the research question of this study, outlines the theoretical framework – contract-enforcement scholarship stemming from the new institutional economics and relational contracting approach developed by socio-legal scholars. Finally, this part discusses the methodology of the research, including its challenges.

CHAPTER 1 RESEARCH DESIGN

1.1 The Puzzle and the Research Question

Modern market economies rest upon a long tradition of enforcing contracts among businesses and developing appropriate institutional structures for this. Contract enforcement is seen as the main institutional pillar that supports the development of market-based exchange (Greif 2008, p. 727). According to North, ‘the inability of societies to develop effective, low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment’ (North 1990, p. 54). Contract enforcement in the broadest sense embraces different ways of securing stable contractual compliance in business relationships. There are a variety of mechanisms in play, ranging from those that are strictly legal such as courts, to purely social mechanisms such as reputation, business networks, personal relationships and many others.

After the breakup of the Soviet Union, rapid economic reforms and the establishment of reliable institutional structures for contract enforcement were considered a priority by post-Soviet governments and the international community alike. Many international development agencies invested and continue to invest thousands of dollars in the post-Soviet countries to improve their court systems, combat court corruption and establish dispute resolution institutions such as arbitration and mediation. By the end of the second decade of transition this process is far from complete. It is undermined by the scarcity of theoretically grounded empirical research, and requires a better understanding of existing contract enforcement mechanisms.

Among all post-Soviet countries Ukraine presents a challenging case in this respect. In terms of economic and institutional development Ukraine often falls into the same group

as Russia. They both lag behind their Eastern European neighbours that are already EU members. However, at the same time, they are more advanced than many Central Asian countries of the former Soviet Union. Similarities between Ukraine and Russia often prompt western scholars to automatically extend the results of studies on Russia to Ukraine and vice versa (Solomon 2008). While in some areas, such as the predatory role of the state, the assumed similarity between Ukraine and Russia arguably still holds true, in other areas it needs to be established.

Ukraine is unique, with its geopolitical location, official European orientation and the harsh reality of its dependence upon Russia. By the second decade of transition, Ukraine differs most visibly from Russia in terms of political development. After the 2004 Orange Revolution, Ukraine was ranked as politically free by Freedom House and recognized as an established market economy by the European Union and the United States (Aslund 2009, p. 5). Despite democratic retreat after the change of government and the imprisonment of opposition leader Yuliya Tymoshenko, by 2012 Ukraine still had some hope of retaining a democratic orientation, whereas Russia was no longer deemed to have taken the democratic path of development¹. Yet Ukraine differs from European, democratically oriented societies in terms of the main impetus behind democratic reforms. Paradoxically it is a highly competitive oligarchy that breeds economic growth and pluralism (Aslund 2009, p. 6).

At the same time, in terms of scholarly interest, Ukraine remains under-researched compared to Russia, especially in the area of business relations. Business-to-business relations in Ukraine have been explored in just a few studies. The most extensive study was sponsored by the World Bank at the end of the 1990s and was a large scale cross-country

¹ 2012 Freedom of The World' Survey by Freedom House ranked Ukraine as 'partly free' and Russia as 'not free' <http://www.freedomhouse.org>; 2011 Democracy Index by Economist Intelligence Unit marked Ukraine as 'hybrid regime' and Russia as 'authoritarian regime' <http://www.eiu.com>

comparison that included Ukraine, among other East European nations (Johnson *et al.* 2002). Another widely quoted study concentrated solely on courts and their influence upon the economic performance of Ukraine's small and medium-sized enterprises (Akimova and Schwodiauer 2005). The rest of the studies are either constrained by narrow organizational needs, such as assessing a potential investment into a specific project – 2007 International Finance Corporation, Ukraine Commercial Dispute Resolution Study (herein after 2007 IFC survey) (IFC 2007); or remain unpublished (Nashchekina and Timoshenkov 2002, Czaban 2003).²

Dramatic political events and vibrant politics in Ukraine have attracted a plethora of researchers mostly in political sciences (Protsyk 2004, Aslund 2009, Polese 2009, Allina-Pisano 2010, Kuzio 2010, Popova 2010, Brudny and Finkel 2011). This focus on wider, macro-political events has perhaps come at the expense of research which has focussed on how ordinary Ukrainian businesses continue to cooperate with each other, provide for their families and ultimately contribute to the country's economy.

Thus in an attempt to understand how things work in practice in Ukrainian business, I concentrate on the contractual pattern prevalent in low-technology moderately competitive industries characteristic of the Ukrainian economy as a whole, and address the following research question: **What are the mechanisms that enforce contracts in contemporary Ukraine and how do they operate to ensure the stability of contractual relations in a transition economy?**

Independent empirically-based academic research that provides answers to the above questions can help us to understand the social demand for court reform, as well as

² A few other recent studies, although they do not address the issues of business-to-business contract enforcement, contribute to the understanding of the wider business environment and show a growing interest in Ukraine (Williams 2009, Round and Williams 2010, Danis and Shipilov 2012, Markus 2012).

for new institutions such as mediation in post-Soviet Ukraine. Implications of this research have the potential to inform further policy initiatives by international donors and local reformers aimed at improving contract enforcement institutions (Gillespie and Nicholson 2012).

To understand the actual practice of contract enforcement it is important to identify the whole spectrum of contract enforcement mechanisms. A survey of contract enforcement literature suggests that the most fruitful way to approach this is to group contract enforcement mechanisms into public and private. The former refers to such mechanisms as courts, and the latter to repeat dealings, self-enforcement, business networks, reputation and the like. By expanding the analysis to account for informal, extra-legal, socially-rooted arrangements that support contractual relations, the socio-legal literature highlights the pervasiveness of these arrangements and the importance of viewing them in their interrelationship with the state legal system. Thus it is crucial to view the contract enforcement system in its entirety, equally comprising the private and public, formal and informal enforcement mechanisms, as well as appreciating the role of each mechanism as a constituent part of this system.

At the same time, contract enforcement cannot be fully understood through the isolated analysis of constituting mechanisms. Socio-legal researchers examine contractual relations within the wider societal context where these relations are rooted (Deakin *et al.* 1994, Arrighetti *et al.* 1997, Hendley 2001, Allen 2002). This approach demonstrates the importance of macroeconomic factors, including the level of competition and the uncertainties of the market; political conditions and stability; the quality of legal regulation, the efficiency of the court system and formal contractual frameworks. All these factors,

which can be put under the umbrella of the business environment, shape contract enforcement in any industry and in any societal setting.

Thus, building upon a socio-legal approach, the logic of analysis lies along the following lines. The thesis first offers an introduction into the wider and immediate business environment. After understanding the specifics of the Ukrainian business environment, the contract enforcement system is broken into contract enforcement mechanisms which are analyzed separately. Finally, the mechanisms are assembled into a contract enforcement system which is explored both in its entirety, and in terms of the interactions between the mechanisms. In this way the socio-legal approach to the analysis of contract enforcement mechanisms places this study in a context that provides a deeper basis for the interpretation of the empirical findings.

Research of Post-Soviet Business Relations

The unique process of institutional development in post-Soviet countries has attracted the attention of many researchers from the early days of transition. The first wave of research on contractual relations immediately followed the breakup of the Soviet Union and produced a strongly negative image of transition.

According to Fuxman, foreign investment in Ukraine is impeded by the absence of ‘any functioning commercial law’ (Fuxman 1997, p. 1276). The courts are believed to be corrupt and judges incompetent – a top American manager advises investors not to ‘even think about getting justice in a Russian court’ (Halverson 1996). Akimova reports that Ukrainian courts claim to be overloaded with applications from creditors, and the official time limits for the consideration of the claims are usually passed (Akimova and Schwodiauer 2005, p. 7). Many researchers find that law generally has little value in post-Soviet dispute resolution (McFaul 1995, p. 95, Aslund 1995, p. 5-7, Eckstein *et al.* 1998, p.

146). Even when one is able to finally obtain a judgment, ‘there are often no institutions to enforce this ruling’ (Hay and Shleifer 1998, p. 398).

There are concerns that in the face of failing courts, informal mechanisms to support contracts do not work efficiently either in post-Soviet economies (Hay and Shleifer 1998, p. 399). Contracts appear often to be breached and sometimes ‘ignored with impunity’ (Filatotchev *et al.* 1999, p. 489). The situation in the post-Soviet economy is referred to by Nashchekina and Timoshenkov as a ‘crisis of contractual relations’, which manifests itself through ‘different types of contract terms violations’ (Nashchekina and Timoshenkov 2002, p. 12). The overall institutional environment in business is seen as deeply criminal (Volkov 1999, Volkov 2002). As Boyko and Shleifer conclude, ‘the result, of course, is that organized crime enters to protect property rights and enforce contracts’ (Boycko and Shleifer 1995, p. 78).

This pessimistic view continues to influence the contemporary vision of post-Soviet business and is echoed in some academic studies (Polishchuk and Savvateev 2004, Gerts 2010, Pakhomov 2010).

Based on this grim view nothing seems to work properly in post-Soviet economies. However, why then have these economies not completely collapsed? How did Ukraine’s economy rapidly improve from 2004-2008 with an annual GDP growth of 7%? If contract enforcement institutions are lacking or fundamentally deficient, how did Ukraine manage to overcome the worst economic crisis in its history in 2008, and return to 5% GDP growth in 2011?³

³ Data and Statistics for Ukraine, World Bank Development Indicators, <http://go.worldbank.org/GPPNM8A3N0>

Perhaps, by the turn of the new millennium these questions have motivated the second wave of research on post-Soviet business which has produced a more positive account. The reasons for this ‘improvement’ are legion.

Hendley, who conducted surveys and in-depth empirical case-studies of the role of law and courts in contemporary Russia, suggests that the dysfunctional nature of post-Soviet courts has been exaggerated (Hendley *et al.* 2001, Hendley 2004a). It is likely that the ‘grim picture’ of business in earlier years of the post-Soviet transition owes much to a selective focus on illegal phenomena such as the criminal enforcement of contracts by ‘violent entrepreneurs’ (Volkov 2002); small business rackets (Frye and Zhuravskaya 2000); *blat*, fake reporting and ‘telephone law’ (Ledeneva 2006). According to Hendley, ‘much of the interest in these mechanisms derives from fascinating case studies of highly specific activities rather than from measures of aggregate importance’ (Hendley and Murrell 2003, p. 52). In a similar vein, Gans-Morse concluded that a narrow focus on high-profile conflicts involving oligarchs ‘offers a skewed and unrepresentative portrayal of modern-day Russian business practices’ (Gans-Morse 2011, p. 37). Indeed, what is missing from the picture is a socio-legal understanding of the relative importance of contract-enforcement mechanisms in the everyday life of businesses (Hadfield 2008, p. 176).

Another explanation for the negative image of post-Soviet business is suggested by Vinogradova (Vinogradova 2005). She points out that many first-wave studies relied upon incomplete secondary data and were lacking in empirical evidence for their conclusions (Greif and Kandel 1993, Halverson 1996, Pistor 1996). The second-wave research is more empirically grounded with an increasing reliance on qualitative research methods or a combination of quantitative and qualitative methods (Hendley *et al.* 2000, Hendley 2001,

Frye 2004, Chepurenko and Malieva 2005, Vinogradova 2005, Williams 2009, Hendley 2010a, Gans-Morse 2011, Markus 2012).

Finally, the speed and the scope of the post-Soviet transformations were unprecedented. It may therefore be the case that improvements in post-Soviet business emerged more quickly than in more stable societies. Institutions that took centuries to mature in the capitalist west transformed Russian and Ukrainian business in years. Thus post-Soviet business in 2010 differs tremendously from post-Soviet business in the 1990s. According to Vinogradova, more primitive and cruel contract-enforcement strategies, like bribing and the use of violence, have given way to more ‘civilized’ practices, like the use of associations and state courts (Vinogradova 2005, p. 205). Gans-Morse concludes that by the second decade of transition, the violent era of business relations in Russia is over (Gans-Morse 2011). Other researchers note the move from personal trust networks, *kryshas*⁴, local milieus and intermediaries to formal institutions despite the lack of trust in the latter (Chepurenko and Malieva 2005, Mollering and Stache 2007).

Thus the second wave of research on post-Soviet business relations suggests a more positive, but much more complex picture of the business practices. This is perhaps unsurprising as its conclusions are based firmly on empirical research and are therefore more sensitive to changes in context.

This study of business-to-business relations in Ukraine aims to contribute to the latter line of research. It is inspired by the desire to offer a more accurate and balanced account of contemporary Ukrainian business and to monitor changes that occurred within the transition period.

⁴ Literately – roof. Unofficial and illegal private protection and dispute settlement services offered to businesses by organized criminal groups or by corrupt state officials (See Volkov 1999).

1.2 Methodology

1.2.1 Methodological Approaches and Data Sources

The empirical part of this research comprises a case study of the contractual practices of three Ukrainian companies and their trading partners from 2007-2011. Each year over the five years I undertook a placement for one or two months with the three companies, located in Donetsk, Ukraine. When I was away from the sites I traced any major developments through telephone updates.

This study was set up to explore contract enforcement among businesses – i.e. legal entities and individual entrepreneurs without the status of legal entities, of any type of ownership and organizational structure including state-owned enterprises and state agencies when they act in a commercial capacity. My focus on business-to-business contract enforcement excluded relations of an administrative nature between businesses and administrative agencies.

Business transactions studied in this research comprised not only sales and purchases that provided for the main activity of the companies (manufacturing, agriculture or retail trade) but also supporting transactions such as office rent, transportation of supplies, purchase of office supplies, use of consulting and other services etc. (for the summary of typical transactions for the three companies see Appendix 2). While relations with banks and other financial services providers fall under the broad definition of business relations, they were excluded from the research data. The companies turned out to be very sensitive to such crucial relationships and were unwilling to share any information on these transactions, especially during the financial crisis of 2008.

Finally, as this research examined the business relationships of the researched companies with their sellers as well as their buyers, the interviews and observations were conducted both at the sales and supply departments and concerned both types of transactions.

The empirical research of contract enforcement mechanisms employed by the researched companies and their trading partners relied upon four major sources of data.

The primary source was face-to-face semi-structured interviews with the employees of the researched companies who dealt with customers and suppliers such as operational-level sales and supply managers, managers of the upper level, heads of department, chief executive officers, owners and lawyers; in courts and at other settings. During the five years more than 40 people, including trading partners of the researched companies, were interviewed; key persons were interviewed up to twenty times. In addition, many short conversations with business people within and outside the researched companies have informed my empirical findings. All interviews were taken in Donetsk at different times. The list of people interviewed in this study is presented in Appendix 1.

Interviewing was supplemented by observations of behaviour and communication of employees among themselves, with their superiors and clients. Owing to the longitudinal character of the fieldwork, it was possible to develop close relationships with the key interviewees at the companies and thus to achieve a high level of interpersonal trust between the researcher and the interviewees. By the end of the fifth year I had learnt quite a deal about my interviewees including their family matters and personal characters. Five years was a long period, some of my interviewees left the companies, two sadly died, and happily two others have had babies. Such a long period of research and close communication with the interviewees allowed for a deeper exposure to real life business

practices beyond the surface of transactions. Positive relations with the key interviewees at the researched companies created a friendly atmosphere around my presence at the sites and facilitated my communication with other employees.

The third source of empirical data comprised relevant written records of all kinds that were available at the companies such as written contracts, specifications, annual accounting reports, accounting records of transactions, pre-trial legal claims, court claims, written informal correspondence, information from the companies' internal data bases etc.

Finally, an important part of the data came from the official court statistics and from open public data bases such as the Single National Registry of Court Judgements of Ukraine,⁵ and the database of the Securities Market Infrastructure Development Agency of Ukraine (SMIDA)⁶.

Selection of the Researched Companies

The major task of this research was to identify the most frequently occurring contractual pattern characterizing Ukrainian businesses. Therefore, the markets of the researched companies in general terms reflected the underlying structure of the Ukrainian economy with its restricted competition and low product customization. Located in a single region of Eastern Ukraine – its most industrial part – the three companies operated in the same wider political and economic conditions, thereby obviating the influence of regional differences.

Taking into account the fact that contractual relations are industry-specific, to identify general patterns across the economy it was decided to choose three companies representing different industries – industrial manufacture, agriculture and services. These

⁵ <http://www.reyestr.court.gov.ua/>

⁶ www.smida.gov.ua

three industries are the most important industries for the Ukrainian economy which contribute the largest share to GDP.

Contractual patterns are also demonstrated by researchers to be contingent upon the size of the companies (Vinogradova 2005). The size of the company and consequent availability of financial and human resources are believed to critically determine contractual relations, in particular the use of courts. Contract enforcement and dispute resolution studies invariably find that larger companies are more likely to use courts to resolve their disputes than small ones (Bigsten *et al.* 2000). The 2007 IFC survey of Ukrainian companies demonstrated that it was the size of the companies that produced statistically significant differences among companies, but not their geographical locality (IFC 2007).

In the context of the post-Soviet transition, the size often, although not always, correlates with other attributes such as the time of founding, the sector of economy, the previous experience of management in the Soviet era, and criminal involvement. Larger companies tend to be old enterprises established in Soviet times mostly in the industrial sector. They survived the collapse of the Soviet Union and were restructured and privatised. In contrast, smaller companies are often recently established in the 1990s and operate in more flexible sectors such as agriculture and services.

Taking into account the importance of the size of the company in determining contractual practices, it has been decided to concentrate on companies of various sizes – a café with 5 employees, a farm with over 50 employees, and an industrial plant with more than 500 employees. According to Ukrainian law this spectrum of enterprise sizes

corresponds to small, medium and large businesses⁷, although remains within the margins of small and medium enterprises according to international classifications.⁸

Finally, because this study seeks to identify broad commonalities among the companies, the selection of the companies deliberately avoided firms with extreme characteristics. Consequently, none of the companies represented an extreme case. They were not exclusively export-oriented; the main bulk of their business was conducted in domestic markets. They were neither single-person companies, nor had more than 1,000 employees. At the beginning of this research in 2007, none of the researched companies operated in a lucrative trade or sector of economy, nor was any company (initially) on the verge of bankruptcy, although by the end of this research in 2011 the Plant suffered from acute illiquidity. Furthermore, although in terms of technology of production and management, the Plant, the Farm and the Café had substantial differences, none of the companies was highly dependent upon a limited number of buyers or suppliers due to the specifics of production or their monopolistic position in the market.

As a result, all three companies could be characterised as middle-range successful businesses. The differences between the companies in terms of their size and technology did not foreclose the opportunity for an exploration of the general broad contractual patterns analyzed within the wider socio-economic context of Ukrainian business. It was anticipated that if three considerably different companies and their trading partners exhibited broadly similar pattern, this would give some grounds to the claim that this experience is relevant to Ukrainian business as a whole.

⁷ Based on the number of employees small enterprises are those that employ less than 50 people, and large enterprises employ more than 250 people with annual profit from sales more than UAH 100,000,000 (US\$ 10,000,000) (Article 63 of the Commercial Code of Ukraine).

⁸ European Bank for Reconstruction and Development classification treats enterprise with 0-9 employees as a micro-enterprise, 10-49 employees as a small enterprise, and anything between 50-250 falling into the category of medium enterprise. See European Bank of Reconstruction and Development, 2010. *SME Finance Facility*. London: EBRD.

1.2.2 Profile of the Researched Companies

Appendix 2 provides background information about the companies researched in this study. The discussion that follows presents a summary of the key attributes or characteristics of each of the companies.

The Plant

The Plant is a medium-large industrial enterprise with more than 500 employees including administrative staff. It produces cable and wires of various technical configurations for the coal, metal, energy and construction industries. Its annual profit from sales was about UAH 240,000,000 (US\$ 24,000,000) in 2007, which classified the Plant as a large enterprise according to Ukrainian law.

The first cable was produced at the plant in 1962. The plant played an important role in the Soviet industrial development of the region. After the breakup of the Soviet Union in 1994 it was restructured with a majority of shares belonging to the state and the rest to the employees. In 2004 the plant was privatized as an open joint stock company by one of the powerful business groups in Donetsk. In 2007 the majority of shares were bought by the Russian company Sevcable. Owing to the substantial investments, the Plant was able to modernize production and in 2007 occupied about 10% of the Ukrainian cable market.

The Plant sells cable directly as a vendor through its onsite shop and as a wholesale trader through its sales department to trading companies and consumers – metallurgical plants, construction companies, machine-building factories, coalmines and others.

In terms of organizational structure, the Plant is a hierarchical manufacturing company with a high level of centralized decision-making. In 2005 the Plant was managed

by a young progressively minded lawyer with a MBA from a Swiss University. In 2008 during the course of this research, the top management of the Plant changed due to new ownership. The executive director was replaced by the former vice-director for sales with a background in economics.

The organizational structure of the Plant was complicated and changed a few times during my five-year research period. Apart from production workshops, it comprised eight other departments. Although employees from all these departments were interviewed in this study, the most relevant departments were Sales, Supply, Economic Security and Legal.

The Sales and Supply departments each consisted of four to five operational level managers and the heads of departments. The Department for Economic Security employed three people and its primary function was to ensure the safety of the Plant's premises and the security of its transactions. Therefore an elaborate scheme of client and supplier screening was in place at the Plant.

The Legal Department consisted of two lawyers – the head of department, a woman in her early thirties and her younger female colleague who entered the Plant immediately after graduation in 2007. The lawyers were primarily charged with drafting and reviewing contractual documentation, attesting the legality of the Plant's transactions, handling court cases and related matters, advising on legal issues of corporate governance and labour relations, and generally on all legal issues that could arise at the company.

Owing to the personality traits of the lawyers and to the fact that the previous director of the Plant was a law graduate, the role of lawyers at the Plant was far from passive. The head of Legal was promoted to Vice-director for Organizational and Legal Matters during the course of this study. She was always actively involved or at least

informed of most of the deals of the Plant. Yet her formal role remained within the confines of ‘technical advisor’ (Hendley 2010b); she seemed to be genuinely uninformed about the strategic decisions of the Plant’s directors and at times seemed frustrated by this situation.

The Plant subscribed to the quality monitoring system ISO 9001:2000. Internal procedures such as client screening, contract drafting and signing, transaction monitoring, quality checks, financial audits, dispute resolution etc., were regulated by detailed internal standards –Guidelines on Payments, Guidelines on the Sales of Goods and Interactions with the Clients, Guidelines on Quality, Guidelines on Legal Support and the Guidelines on Corporate Culture among others.

The Plant signed contracts with around 500 buyers and suppliers annually. The contracts were generally executed smoothly by the Plant and its trading partners. The percentage of contract breaches in Sales did not exceed 9% of transactions even during the financial crisis in 2008-2009 (Appendix 2). More than 90% of these contract breaches were caused by payment problems.

Payment delays by the Plant’s buyers slightly increased in the aftermath of the 2008 economic crisis, but the contracts were rapidly renegotiated in January-April 2009 and the payment routine restored. Those buyers who found themselves in financial distress simply stopped buying cable and the Plant’s sales dropped by almost two thirds. In contrast, payment delays by the Plant to its suppliers remained a profound problem. From 2009-2011 the Plant was reported regularly to delay 80% of payments under its trade credit contracts. As a result, the number of legal claims against the Plant increased fivefold in 2011 compared to 2008, and the number of court cases rose from zero in 2008 to four in 2011.

Late delivery and quality or quantity defects in goods or services were rare problems for the Plant. In 2011 the Plant's Quality Department registered fifteen cases of non-conforming inputs supplied by various suppliers that made only 1-2% of total supplies. And out of eight claims regarding deficiency of the Plant's cable, only one was ultimately proved true and resulted in the cable being replaced.

All the initial contractual problems of the Plant were dealt with at sales level by managers or other employees and only in some cases were lawyers involved. The procedure of referring the case from the Sales level to the Legal Department was comprehensively regulated by the Guidelines on Payments in the following way.

After the fifth day of payment delay the Guidelines prescribed that the employee in charge of the transaction to make a telephone call to the debtor and to request payment, or an explanation for the delay. Delays from five to ten days required a letter signed by the head of Sales and addressed to the top managers of the debtor. Delays from ten to fifteen days warranted a second letter of the same type. When the delay amounted to more than fifteen days, the employee in charge of the transaction had to request the Director of the Plant to transfer the case to the Legal Department for pre-trial claim procedures. In exceptional cases the time limit of fifteen days could be extended by the Director of the Plant up to one year, provided the debtor presented sufficient guaranties of payment.

The cases from the other departments were referred to the lawyers in a more arbitrary fashion depending upon a subjective understanding of the urgency and complexity of the matter by the operational managers.

When lawyers became involved in the resolution of contractual disputes they occasionally continued negotiations with the trading partners, but in most cases relied

primarily on pre-trial claims (*pretenziya*)⁹ and the courts. Both were exceptional strategies used in respect to less than 1% of transactions.

The Farm

The Farm was a medium to small business with up to 60 employees – eight persons managing the business and the rest working in the fields. It was officially registered as a Limited Liability Company in 1996 by a recent law graduate with two close friends. They were supported by the lawyer's father, a well known director of the local collective farm in the Soviet times, and a successful businessman in transition times. The Farm began to operate only in 2002.

Owing to the painful reforms in Ukrainian agriculture and the introduction of dispersed private land ownership, state and collective farms were dismantled and farm property was divided among the farm workers as land shares. However, most Ukrainian farmers were not able to sustain their businesses independently and were forced to turn to outside investors.

The Farm owner as the investor rented the plots of land from individual farmers; he managed the work of the Farm, purchased machines and other equipment, seeds, and chemicals etc. Thus it was not a farm in the common sense, but rather a group of independent farmers jointly working on their land, sponsored and managed by the outside investor.

The Farm's office was staffed by the executive director, the general manager (referred to in this study as the Farm Manager), the accountant, the secretary and the

⁹ Pre-trial claim - *pretenziya* – a formal letter written under the template provided by the Commercial Procedural Code; it contains description of the facts of the case, the claims of the aggrieved party, calculation of damages and penalties, references to laws; and includes appendix with the copies of documents to support the claim.

owner. The office was located in a town, while the fields were in the countryside two hours' drive from the office. Everyday field work was supervised by the onsite manager, while operational management was done through the city office.

The executive director turned out to largely be a virtual figure; his responsibilities were confined to signing formal papers and meeting local authorities for 'unpleasant talks'. Instead, the Farm Owner himself, along with the Manager, dealt with all the matters and took all executive decisions regarding all aspects of the Farm's operation.

The Farm produced four kinds of agricultural crops – wheat, corn, millet and sunflower seeds. Its annual profit from sales was approximately UAH 10,000,000 (US\$ 1,000,000) over the years of this research. It sold directly to end users such as poultry producers, oil processing plants, and bakeries etc., and wholesale dealers who mostly exported the yield through the Azov Sea port. A secondary, but sometimes quite lucrative, activity was the provision of harvesting services by the Farm's combines to neighbouring farms.

The Farm contracted with around 100 buyers and suppliers annually. Fortunately, the economic crisis of 2008 did not affect the demand for agricultural products produced by the Farm and had almost no impact on the enforcement of contracts with its trading partners.

The Farm turned out to have the highest rate of contractual violations among the three companies – 13.8% of transactions. Similar to the Plant, these contractual violations comprised mostly payment delays. The Farm was always less punctual in payments than its buyers. For example, in 2008 the payment delays by buyers to the Farm were registered only twice, while the Farm was in arrears to its suppliers 39 times. However, these delays were always of a few days long or in respect to negligible amounts.

Similar to the Plant, late delivery was a rare problem for the Farm and most of the late deliveries were caused by its suppliers. Quality and quantity defects presented the minor part of contractual problems, although they were the most challenging (for example see the Case No 2.1 Don Combine, Case No 2.6 Newholland Combine, Appendix 3).

The Farm has not developed any standards that regulated its internal procedures. Contracts were negotiated on a case-by-case basis by the Farm Manager and signed by the executive director. All contractual problems were dealt with primarily by the Farm Manager, the Farm Owner was involved only in certain cases, such as when the relationship was solely supervised by him or when the Farm Manager was unable to solve the problem. However, the Farm Owner approved each single transaction and was informed of all significant contacts with the trading partners.

The Farm rarely used *pretenziya* in relations with defaulted trading partners, and appeared in commercial courts only three times in the period 2004-2011.

The Café

The Café was a small business operated by a sole entrepreneur in her mid-forties. She began her business in 1995 by assisting her husband in establishing a beer retail chain. By 2002 they ended up managing about 60 kiosks and three larger cafés, with about 70 employees in total. By 2004 the number of kiosks fell to ten. At that time her husband was no longer involved in their retail business. At start of this research in 2008, owing to the conflict with the local authorities, her business had shrunk to two sites - a small café at a swimming pool, and a kiosk on the central street of Donetsk. By 2012 she retained only a street kiosk.

In 2007 the Café Owner hired five people to work in the café and the kiosk. They sold and served basic snacks and beverages, including beer and soft drinks. Besides her

permanent sites she was often invited to serve at street festivals and sport events. The Café contracted annually with around twenty suppliers and four landlords. It sold directly to consumers and thus was not involved in any commercial sale transactions. The Café received supplies from vendors and a few producers – local bakeries. The Owner ordered goods through sales agents of the vendors who came on site at least a few times a week to bring goods and take orders.

The Café also rented sales equipment such as stands and fridges from its vendors, and trading spaces for her street kiosk from the City Council and for the café at the swimming pool from the private owners. Occasionally she had to lease additional trading spaces for public events organized by the City Council and private companies.

The Café had the fewest contractual problems compared to the Plant and the Farm, amounting only to 0.6% of transactions. And these contract breaches were qualitatively different from both other companies. Owing to the spot market nature of the Café's transactions, payment breaches amounted to zero, instead the quality and the time of delivery became a major concern but only on special occasions – when the Café was serving public events. Because of the importance of timely delivery on these days, the Café Owner warned her suppliers well in advance and made sure they understood the instructions. During the period 2007-2011 only one delay of this type was reported to have happened. The local Coca Cola company delayed delivery of beverages for a few hours during the street festival on Children's Day (Case No 3.1 Coca Cola, Day of Children, Appendix 3). The quality and the quantity of the Café's supplies almost never presented a problem because of the highly standardized nature of the goods. Furthermore, as the supplies were of small quantities they were easy to check upon delivery.

All problems with vendors including minor ones were handled solely by the Café Owner and mostly by phone. The Owner's hired salesmen were not involved with any communications with the Café's trading partners except receiving goods. This is an account of one of the salesmen:

If the sales agents deliver wrong goods I call the Café Owner and she calls the manager. She decides whether to accept the goods or to return them partially. If the truck does not arrive on time, she always knows this because she calls me and asks herself. When this happens she calls the manager [Salesman A, the Café, interview on 8 December 2008]

Using *pretenziya* against vendors or suing them in courts was unthinkable for the Café Owner. Yet she became involved in a protracted conflict with one of her landlords over the rent which resulted in the use of *pretenziya*, two law suits in commercial courts, and one criminal case against the Café Owner (Case No 3.4 Leisure Park, Appendix 3).

1.2.3 Methodological Challenges

The value of interpretative qualitative methods in socio-legal research such as case studies which rely upon fieldwork is well recognized, although researchers are warned openly to acknowledge the methodological limitations of their studies (Diefenbach 2009, p. 890-891).

In order to select the companies for research and to gain access to them, I relied upon my personal connections as a member of the local community where the research took place. However, it did not affect the outcome of the research. Although they provided primary access to the interviewees, my initial connections with senior managers in the researched companies lost their importance in the long run. Established relationships with many other employees of the companies made it possible to conduct interviews without reference to senior managers. For example, the initial contact of the Plant – its Director – left the Plant in 2008, but I was still able to conduct my fieldwork there until 2011.

More problematic was the access to interviewees in particular departments within the companies, which is believed to exert a greater impact upon the internal reliability of data than the selection of the research sites (Diefenbach 2009, p. 880). Fortunately, I was not constrained by the choice of interviewees at the Café and the Farm and was able to talk to anybody freely. Nor was I limited in my choice of interviewees by the Plant's organizational policies.

However, the 2008 economic crisis caused problems for some of my initial plans. The Plant's Supply Department turned out to be most affected by the crisis and by staff turnover. By the second year of the fieldwork my access to the Supply Department was seriously restricted. Although I managed to interview a supply manager, the Vice-director for Supplies and the Head of the Supply Department, I was not able either to observe directly the work of the Department or to talk to other supply managers. During 2009-2011 most of the information on supply transactions was obtained through lawyers who had access to the Plant's databases and documentation.

Finally, the differences in the organizational structure of the researched companies present a methodological problem for the comparability of data stemming from the various sources. The data sources appeared to be unequally available and accessible across the three companies. The Plant had the most full and accurate recordkeeping, but a huge number of transactions and limited access to some records. The Café kept very limited written records but had quite simple transactions of a manageable quantity that allowed for full and detailed oral recollections and physical observations. The Farm proved to be the most balanced in respect to accessible sources and the number of transactions.

These methodological challenges were dealt with in the following ways. First, the empirical research took the path of a longitudinal study. According to Banakar and Travers:

from an interpretive perspective, it is usually preferable to conduct one in-depth case study, based on a long period of fieldwork, as opposed to spending shorter periods of time in two or more settings (Banakar and Travers 2003, p. 21)

Although the fieldwork in Ukraine started in 2007, the economic crisis of 2008 prompted subsequent research. The crisis presented a unique opportunity to record the first-hand experiences of a business in crisis and to identify any shifts in contract enforcement strategies.

Second, the longitudinal character of the research allowed for greater flexibility in interviewing. The internal reliability of the data was enhanced by ‘asking the same people many times’ and ‘asking different people about the same issues’ (Diefenbach 2009, p. 882).

Third, enquiries about contract enforcement were not limited to the companies subject to this research. It takes two to conduct a business relationship. Therefore, along with the three researched companies, this study took a snapshot of the contract enforcement practices of around 500 trading partners of the researched companies. Furthermore, the interviewees, as experts in their business, were able to comment on the general practices prevalent in the respective industries.

Lastly, in order to improve the quality of empirical data I used a method of data triangulation (Diefenbach 2009, p. 882). My research triangulated the results from interviews with onsite observations, a close examination of written records and statistical information. Interviews and observations enabled me to combine the qualitative data with greater insights into the attitudes and perceptions of the interviewees. Written records and statistical information from the databases provided a wealth of quantitative information on actual transactions, contracts, pre-trial claims, court cases, etc. All in all this provided an in-depth and balanced insight into business relationships at the researched companies.

Such depth and richness of empirical data stemming from varied sources, collected over a five-year period, provided a unique opportunity to render some conclusions about contractual pattern prevalent in low technology moderately competitive industries in Ukraine. At the same time it is acknowledged that any attempts to generalize the conclusions of this study must be made with the caution intrinsic to highly qualitative research methods (Kurkchyan 2009, p. 344). The other patterns may occur in Ukraine's innovative or highly competitive industries which require further research.

1.3 The Structure of the Thesis

The thesis consists of three parts conditioned by the logic of the analysis. The first part sets the scene for the study; the second part introduces the reader to the business environment of post-Soviet Ukraine; the third part explores the separate contract enforcement mechanisms. The concluding chapter 'assembles' these mechanisms into a contract enforcement system and discusses this with reference to environmental context of Ukrainian business.

Chapter 1 presents the main focus of my research – contract enforcement mechanisms within the contractual pattern prevalent in low-technology moderately competitive industries characteristic of the Ukrainian transition market as a whole. It substantiates the importance of contract enforcement institutions for post-Soviet transition, highlights inconsistencies in existing research and presents my research question. The chapter also describes the empirical methodology of this socio-legal research which is based upon case studies of three Ukrainian companies. The chapter introduces the researched companies and explains the logic of their selection. Lastly, it discusses some of the methodological challenges encountered in this study.

Chapter 2 presents two theoretical approaches – contract enforcement and relational contracting – that provide the conceptual tools to address the problem of contract

enforcement in Ukraine. While originating from different areas of research, these approaches challenge the frictionless vision of contracts and the idea that all disputes are settled perfectly by law. They highlight importance of informal, extra-legal, socially-rooted arrangements that support contractual relations and should be viewed in interplay with the legal system placed within the context of wider business environment.

Although contract enforcement offers the primary theoretical framework for this study, relational contracting also lends some useful insights by highlighting the formal and temporal dimensions of contracts and the differentiation between discrete and relational modes of contracting. As my research will demonstrate, even within a single societal setting, contract enforcement mechanisms may operate differently in contracts with first-time and with long-standing trading partners.

Prompted by the need for a socially oriented contextual analysis of contractual relations, Part 2 of the thesis explores the environment of contemporary Ukrainian business.

Chapter 3 offers an introduction into the wider business environment in Ukraine which is characterized by limited market openness, the negligible customization of production, macroeconomic and political uncertainties, and the predatory role of the state. The chapter looks at these environmental characteristics through the eyes of Ukrainian businesses and concludes that they operate in a largely alien, uncertain and predatory business environment.

As Chapter 3 ends with a very grim picture, the importance of the immediate contractual setting in cushioning shocks from the wider environment becomes evident. Therefore, Chapter 4 is devoted to an analysis of written contracting practices at the researched companies and their trading partners. The chapter brings to light the formal

characteristics and the actual functions of contractual documents in Ukrainian business. It concludes that the overwhelming use of written contracts in Ukrainian business, although prompted by factors very remote from the enforcement of contractual promises in courts, has indirectly contributed to the stability of contractual relations.

Having gained some understanding of the context within which contractual relations are embedded in Ukraine, Part 3 proceeds to explore the separate contract enforcement mechanisms, their functions and interrelations.

Chapters 5 and 6 look at the very foundation of contractual relations rooted in private arrangements, and are devoted to the analysis of private contract enforcement mechanisms. Based on the empirical findings on the relative importance of the mechanisms, Chapter 5 presents the main private mechanisms of repeated dealings and self-enforcing devices that dominate the majority of business relations of the researched companies.

Chapter 6 examines the less vital, yet still supporting, mechanisms of personal relations, reputation and business networks. Most importantly, Chapter 6 draws attention to the exceptional contractual relations involving state enterprises, state agencies or private companies where contract enforcement mechanisms often failed to enforce contracts. Contract enforcement in these relationships is entrenched in repeated dealings and self-enforcing devices, but supported by qualitatively distinct mechanisms – kickbacks from suppliers and administrative resources¹⁰. This chapter concludes that although this exceptional pattern is relevant to the clear minority of business relations in Ukraine, it is more troublesome for private businesses.

¹⁰ Administrative resources are defined as ‘the use of bureaucratic hierarchies and the material resources of public institutions’ to advance private gains (Allina-Pisano 2010, p. 374)

Chapter 7 continues to analyze contract enforcement mechanisms in Ukrainian business and concentrates on the public mechanisms of the courts and court-related pre-trial claims (*pretenziya*). Based on the sample of disputes where the law has been expressly mobilized, the first part of the chapter explores ‘legal’ and ‘non-legal’ uses of *pretenziya* by Ukrainian businesses. The socio-legal analysis of this ‘outdated’ Soviet legal institution highlights its creative use by contemporary Ukrainians and shows how it has equally supported private and public contract enforcement.

The second part of Chapter 7 is devoted to contract enforcement through Ukrainian commercial courts. It demonstrates that most commercial court cases related to the researched companies were of a routine nature; they were treated by courts in a fairly efficient manner, albeit through passive ‘rubber-stamping’, with resulting judgments promptly and fully enforced. At the same time, a minority of court cases went through the ‘dark’ part of the court system where corruption and administrative resources were activated to subvert the delivery of justice.

The concluding chapter summarizes the findings of this research. It highlights the overall effectiveness of contract enforcement mechanisms, and uncovers the specifics of these mechanisms which distinguish Ukrainian businesses from their counterparts elsewhere. The chapter demonstrates how these specific features are determined by the factors of the wider business environment. It concludes that the contractual pattern prevalent in low-technology moderately competitive domestic industries in Ukraine effectively serves straightforward traditional buyer-seller transactions. However, it is ill-suited to meet the requirements of globalized trade, production diversification and technological progress. Adaptations of the existing system to meet these requirements are

likely to depend upon changes in the wider business environment, namely upon institutions constraining the coercive power of the state.

CHAPTER 2 THE THEORETICAL FRAMEWORK OF THE RESEARCH

The research question of this thesis is set up to investigate various ways of supporting contracts in society. For a long time, the traditional view of contract, influential in legal and economic scholarship, relied upon assumptions of the equality of the parties who enter into the exchange relationship in the expectation that it will be legally binding and enforceable by courts (Vincent-Jones 1989, p. 16-17). In economic theory, the contract was confined to an economic exchange of a one-dimensional product at a single point in time (North 1990, p. 52). It was assumed that, based upon complete and symmetrical information, individuals as rational actors are capable of designing the most efficient arrangement for their economic exchange. In this perspective, contractual compliance is perfectly guaranteed by the state courts, and the relational dimensions of the exchange are irrelevant for its ultimate success.

By the end of the last century, this traditional view of contracts in mainstream legal studies and economic theory had been successfully challenged by two strands of research, which in general terms could be referred to as contract enforcement and relational contracting. The notion of contracts was re-evaluated towards a more societal approach where ‘economic purposes and actions are deeply embedded in social fields, in densely woven webs of local customs, conventional morals, bonds of loyalty and entrenched power hierarchies’ (Gordon 1985, p. 574).

This chapter offers a literature survey of both research strands and provides the theoretical framework that forms the backbone of this research.

2.1 Contract Enforcement

2.1.1 Underlying Ideas and Assumptions

Contract enforcement in a very broad perspective can be seen as a part of an intellectual endeavour to understand the institutional structure of society and the links between this structure and economic growth – both in developing and developed economies.

Contract enforcement became one of the central themes in research that identifies itself with the new institutional economics. Its proponents believe that policy analysis should be guided by real world institutions rather than ideal conceptions. According to Klein, new institutional economics combines economics, law, sociology, anthropology, and political science to understand social, political and commercial institutions (Klein 2000). It is focused on institutions as the interplay of written and unwritten rules, norms and humanly devised constraints, in their interactions with organisational arrangements (Menard and Shirley 2008, p. 1).

According to the founders of the new institutional economics, ‘the measurement and enforcement costs are the sources of social, political and economic institutions’ (North 1990, p. 27). Therefore, in the sphere of economic exchange, contract enforcement occupies a paramount place. In this line of argument, North forcefully claimed that ‘the inability of societies to develop effective, low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment’ (North 1990, p. 54).

Many contract enforcement studies are policy-driven in the context of globalization, the increased concern with underdevelopment and the proliferation of foreign aid to developing countries and countries in transition (Sokoloff and Engerman 2000, Acemoglu

et al. 2001, Trebilcock and Leng 2006, Chavance 2008, Gechev 2008, La Porta *et al.* 2008, Shirley 2008). These studies attempt to find a reliable policy solution to the question of the most efficient institutional structure to adequately support productive business relations and foster economic growth in the developing world.

The importance of institutional structure for contract enforcement becomes even more pronounced in the context of post-Soviet transition. In the circumstances of the profound and ongoing changes in the post-Soviet societies, uncertainty doubles, the costs of obtaining information on the monitoring of transactions becomes very high, and exogenous shocks and shifts in bargaining power of the parties are common. As demonstrated by Meyer and Peng, opportunistic behaviour in these circumstances is more likely and requires sufficient effort in the establishment of an institutional structure for contract enforcement (Meyer and Peng 2005, p. 610).

Contract enforcement literature that relies on a broadly institutional approach departs from the traditional analysis of economic activity with respect to several assumptions.

The first assumption acknowledges the uncertainty of economic action and the bounded rationality of economic agents (Beckert 1996). In contrast to classical economics with its under-socialized complete rationality, contract enforcement studies in the institutional tradition assume that all humans are rational but only to a certain extent because of the real-life conditions of incomplete and asymmetric information, but also because of the profound constraints posed by the institutional environment itself.

In turn, this opens up the possibility of conscious contractual breaches, or the opportunism defined by Williamson as ‘self-interest seeking with guile’ (Williamson 1985, p. 47). The prevalence of incomplete and asymmetrical information about market

conditions, preferences and the expectations of others, even about their own preferences and the best course of action, makes the resolution of contractual problems of vital importance for the survival of business.

The second assumption of contract enforcement studies proceeds from the recognition of the social embeddedness of economic action (Rooks *et al.* 2000). This postulates that any economic action is embedded in the social structure which means that the actors:

do not behave or decide as atoms outside a social context, nor do they adhere slavishly to a script written for them by the particular intersection of social categories that they happen to occupy. Their attempts at purposive action are instead embedded in concrete, ongoing systems of social relations (Granovetter 1985, p. 487)

This fundamental assumption of social embeddedness aims to view contractual relationships within the wider social, political and economic environment and to embark upon a contextual analysis of contractual relationships. Research in new institutional economics and law and development studies has explored various levels of institutional environment where contractual relationships are entrenched.

For example, Williamson has separated informal institutions, customs, traditions and religion that take hundreds or even thousands of years to mature into the first basic level of institutions. Formal rules enshrined in laws concerning polity, judiciary and bureaucracy constitute the second level; and governance structures, in particular the contractual frameworks, which are aligned with transactions, – the third level of institutions (Williamson 2000). Seen in this perspective, the business environment is not homogeneous and consists of various layers of a varied nature which are mutually dependent and interrelated.

Based upon two basic assumptions of the uncertainty of economic action and its social embeddedness, the focus of contract enforcement studies has shifted from public courts to the contract enforcement strategies of businesses, resulting in the creation of a private order among them, constraints of the institutional environment, and the interrelations of public and private order in this process.

The change of emphasis triggered a number of fascinating empirical studies of private ordering in historical perspectives, such as the studies of the eleventh-century Maghribi traders by Grief (Greif 1989), and of medieval Europe's merchant guilds by Milgrom, North, and Weingast (Milgrom *et al.* 1990). These studies depict highly effective autonomous, largely self-enforcing, regimes of private ordering which did not rely on state courts.

In a similar vein, empirical studies of contemporary US business by Bernstein and Richman document how multilateral private order mechanisms based on networks survived in the diamond trade and the cotton industry. Entry into these specific trades was restricted to intergenerational firms or traders with a specific ethnic or religious origin such as Ultraorthodox Jews. The rejection of trade opportunities was supported by non-economic sanctions of social exclusion from social events, wives clubs, and debutante balls in the cotton industry (Bernstein 2000), and from the intimate religious rituals, celebrations, and life cycle events of the Ultraorthodox Jews who dominated the diamond industry (Richman 2004).

To conclude, a contract enforcement approach implies that contract enforcement is better comprehended in a context of a broader institutional environment of various levels that shapes contract enforcement mechanisms into a blend that is unique for each society. Contract enforcement which originates in legal and state coercion presents only a part of

the story, and there are many other private, informal, decentralized means that support contractual relations.

2.1.2 Contract Enforcement Mechanisms

Apart from the general points noted above, the literature seems quite vague on defining contract enforcement. Many studies either explicitly or implicitly identify contract enforcement with institutions. For example, Fafchamps treats contract enforcement as ‘an institution that deters opportunistic breach of contract’ (Fafchamps 1996, p. 427), and relies on North’s definition of institutions as ‘formal rules and informal constraints that govern human behaviour’ (North 1990, p. 4).

Other scholars, namely in law and economics, have built their research on the theories of social control and explored contract enforcement through the analysis of the economic efficiency of social norms (Ellickson 1987, Cooter 1993, Bernstein 1996, Katz 1996, Posner 1996). For example, Ellickson argues that social norms developed within a private context are effective as they are inherently designed to maximize the public good without state intervention (Ellickson 1991). Thus alongside the phrase ‘contract enforcement’, researchers employ variety of other terms– practices, strategies, institutions, mechanisms, etc.

Given the variety of conflicting views, this study relies upon the most comprehensive approach that allows me to embrace the widest possible spectrum of arrangements to support contracts. Following the mechanism-explanatory view summarised by Hedstrom and Ylikoski (Hedstrom and Ylikoski 2010), this study treats contract enforcement as a system of contract enforcement *mechanisms* whose operation is directed towards producing a clearly articulated result – the systematic and effective performance of

contracts between contracting parties and the achievement of the economic goal of exchange.

As a complex phenomenon, the contract enforcement system consists of a number of contract enforcement mechanisms of a varied nature which, in contrast to the effect of the overall system, are not easily identifiable. As commented by Hedstrom and Ylikoski, ‘sometimes finding underlying mechanisms is the hardest part of the scientific work’ (Hedstrom and Ylikoski 2010, p. 56).

Some mechanisms such as courts and business associations have a formal organizational nature; others such as a repeated exchange mechanism may be viewed as referring to a specific structure of business relationships or incentives for certain behaviour (Fehr *et al.* 1997). Some mechanisms, namely public courts, originate in the coercive power of the state, and many others in essentially private informal and fluctuating normative frameworks. Most contract enforcement mechanisms operate *ex post* – after the contract is broken and a dispute arises; yet preventive *ex ante* mechanisms such as self-enforcing contractual devices are increasingly acquiring greater weight in business. Finally, each contract enforcement mechanism may perform a number of various functions that stretch beyond the straightforward enforcement of contracts.

To conclude, contract enforcement in this study is treated as a system of mechanisms of a widely diverse nature referred to as contractual pattern. The mechanisms perform a variety of functions but are united by a single purpose – assuring contractual compliance and thereby contributing to the economic activity of society.

Types of Contract Enforcement Mechanisms

The diverse nature of contract enforcement poses certain challenges in respect to the typology of the mechanisms. For example, even within a single national context – Russia –

the typologies of contract enforcement mechanisms can vary notably. Vinogradova and Hendley et al. came up with quite different lists of contract enforcement strategies identified in their studies of post-Soviet Russian business (Hendley *et al.* 2000, Vinogradova 2005). Some of the strategies seem to differ only by name (self-enforcing devices in Hendley et al. and financial tools in Vinogradova; the administrative levers of state in Hendley et al. and the threat of punitive actions by state officials in Vinogradova); whereas others were explored through substantially different concepts such as relational contracting and business networks.

Moreover, there seems to be no universal agreement even with regard to the very broad groups of contract enforcement mechanisms. Following the distinction between formal and informal institutions made by North (North 1990, p. 4), many scholars distinguish between formal and informal contract enforcement (McMillan and Woodruff 2000, Trebilcock and Leng 2006, MacLeod 2007).

However, this approach proved to be problematic as some mechanisms could be described as formal and informal at the same time. For example, contract enforcement through protection agencies is referred to by some scholars as formal contract enforcement mechanisms (Radaev 2001), however in practice they display a great deal of informality. Some scholars of post-Soviet transition understand informal activities as explicitly criminal (Kolesnikova 2002) or only partly lacking legitimacy (Ledeneva 2006, p. 192). Therefore, the vagueness of the formal-informal distinction of institutions has prompted some researchers to suggest either abandoning its use or using it with extreme care (Hodgson 2006).

The distinction between legal and non-legal elements of contract enforcement does not seem reliable either. Sometimes, contract enforcement through the courts is labelled

‘legal’ (Vincent-Jones 1989, Charny 1990) or ‘contractual’ (Macaulay 1963), indicating the actual or potential use of state law as opposed to extra-legal, extra-contractual enforcement relying on conventions, usage, custom, or expedient rationality (Vincent-Jones 1989, p. 171-172). However, in the post-Soviet context, the legal-illegal distinction is complicated by the possibility of ‘shadow’ contract enforcement mechanisms, for example, the use of kickbacks from suppliers or violence by criminal enforcers. A whole range of adjectives for such practices has been employed by researchers of the post-Soviet transition – ‘semilegal, extralegal, quasilegal, supralegal, non-legal, illegal’ (Ledeneva 2006, p. 26). All of this renders the distinction between legal and non-legal quite ambiguous.

Given the variety of conflicting views, this research builds upon the least controversial classification of contract enforcement into two very broad groups – public and private.

Public contract enforcement is distinct from private enforcement as it relies on fundamentally different type of resources – state coercion supported by the state bureaucratic apparatus. In the context of business-to-business relations, public contract enforcement is confined to public courts. Thus for the purposes of this research, public contract enforcement encompasses dispute resolution by the state courts and state agencies on behalf of the state. Private mechanisms include all the remaining mechanisms stemming from the community or the business - trade associations, private arbitration, mediation, repeated dealings, reputational mechanisms, etc.

The distinction between public and private contract enforcement does not exclude from our analysis those devices that have a mixed public-private nature. In the context of post-Soviet business, such border-line mechanisms include, for example, *pretenziya* – formal letters written under a specific template and addressed to the delinquent trading

partner. On the one hand, a *pretenziya* is a solely private bilateral mechanism, as no state or governmental agency gets actually involved in its operation. *Pretenziya* is exchanged between two trading partners with discretion and concerns their commercial relations. On the other hand, a *pretenziya* relies heavily on the threat of public courts. It most noticeably transforms a bilateral disagreement into a legal dispute through legal discourse and the threat of legal sanctions. Thus *pretenziya* constitutes a bridge between the private and public realms, as well as the business and legal. Yet the threat of court action lies at the heart of this otherwise private mechanism. Moreover, interviewees in this research treated *pretenziya* as very distinct from bilateral negotiations strategy involving the law, lawyers and courts. Therefore, *pretenziya* is more appropriate for analysis within the public contract-enforcement mechanisms in this study.

Thus having surveyed contract enforcement literature for a reliable typology of contract enforcement mechanisms, I opted for a very basic, yet most reliable, distinction between public and private contract enforcement.

Opening the Black Box of Private Contract Enforcement

Compared to state courts, private contract enforcement mechanisms are generally more diverse, informal, intangible and complex.

Contract enforcement invariably begins as bilateral contractual arrangement between two or more parties to the relationship that accommodates a routine transaction and seeks to prevent disputes. Even when disputes arise, bilateral mechanisms are usually the first option of the parties in their efforts to continue with the transaction. A substantial transformation of the relationship occurs when the relationship is entered into by a private third party, be it mediator, arbitrator, trade association, or any other intermediary or audience who facilitates negotiations between the parties, adjudicates the matter, or

punishes the defaulter. Thus private contract enforcement mechanisms fall into two categories: bilateral and third-party mechanisms. The former covers repeated dealings, prepayment, and personal networks, and the latter covers reputational mechanisms, arbitration, mediation, trade associations, private intermediaries, etc.

Apart from the distinction between bilateral and multilateral enforcement, many researchers distinguish between organized or designed (trade associations), and organic or spontaneous mechanisms (repeated interactions, community reputation systems) depending upon the details of emergence and degree to which institutions are codified and responsibility for enforcement is centralized with identifiable functionaries (McMillan and Woodruff 2000, Greif 2008). According to Greif, organic contract enforcement mechanisms emerge spontaneously as ‘unintended and unforeseeable results from the pursuit of individual interests’; designed institutions reflect an ‘intentional and conscious design and possibly the coordinated responses of many individuals’ (Greif 2008, p. 731).

While bilateral contract enforcement mechanisms emerge spontaneously, multilateral institutions could originate either in spontaneous social processes or in conscious efforts and the financial investment of the business community in the establishment of organizations to support the contractual compliance of its members. For example, being in essence a multilateral mechanism, reputation is capable of operating as a spontaneous arrangement (uncoordinated gossip) as well as at a multilateral designed level (reputational transfers through business associations).

To illustrate this point, consider the contract enforcement system of the eleventh-century Maghribi traders researched by Greif. He showed how Maghribis implemented interdependent trade arrangements operating through overseas agents who comprised solely of Maghribis. The rapid circulation of information inside this ethnic network provided for

the prompt detection of cheating even at distant localities, and made the punishment of the defaulter the economic interest of each network member (Greif 1989). The effective operation of multilateral reputation mechanisms in the closed networks of tight-knit ethnic communities was demonstrated to be feasible owing to the restricted number of network members and naturally interdependent links.

Thus while courts as public contract enforcement mechanisms are always third-party, centralized and organized, private contract enforcement encompasses more diverse mechanisms – bilateral and multilateral, designed and spontaneous. These complexities present certain challenges for empirical research into private ordering.

Apart from official accounting records which do not tell us much about the relationship, private enforcement in most cases lacks formality, written records or other visible signs. Contractual relationship acquires a certain shape owing to various incentives, perceptions and the expectations of the parties. For example, a relationship based on the repeated dealings of the parties relies on the threat to terminate the relationship and the incentive of future gain from cooperation; a relationship rooted in personal relations is motivated by the desire to keep the pleasure of friendship and the personal benefits that stem from this. Perceptions, incentives and expectations present a challenge even for a highly qualitative type of empirical research.

Furthermore, while it is analytically possible to separate one private contract enforcement mechanism from another (for example, repeated dealings from personal relations), in reality they are so interrelated to the extent that may be viewed as one complex mechanism. Therefore, it is not surprising that, for example, such an important bilateral contract enforcement mechanism as repeated dealings is sometimes analyzed as a business network and is overshadowed by this (Vinogradova 2005).

The difficulties of researching private contract enforcement mechanisms also stem from the fact that many of them have other than enforcement purposes, and enhancing contractual compliance is only a supplementary function. For example, in his summary of designed contract enforcement institutions, Greif points out their functions such as matching savers with investors and the smoothing of consumption, but stresses that contract enforcement remains an integral and important part of their operation (Greif 2008, p. 744).

Confirming the above view, the present study has found that, for example, in the post-Soviet context, mechanisms of prepayments and trade credits are primarily part of pricing mechanisms with their own economic functions for the survival and profitability of the company, whereas contract enforcement is of only secondary importance. Personal relations and kickbacks from suppliers (*otkat*) serve the purpose of attracting new orders in the first place, and contract enforcement is secondary to this.

To conclude, private contract enforcement mechanisms are fluid, imprecise and almost intangible. They are such an integral part of the modern economies that ‘it is easy to lose sight of their importance’ (Greif 2008). This study has attempted to decipher these ‘intangible’ mechanisms through the thoroughly qualitative methodology discussed in Chapter 1.

2.1.3 Public versus Private Contract Enforcement

Carried out in the context of development, most contract enforcement studies either implicitly or explicitly engage with debates about the interrelations of public and private contract enforcement in less developed nations.

The normative level of the debate is dominated by the view that strong public enforcement through the courts is indispensable to economic growth (North 1990, Kranton 1996, Posner 1996, Katz 2000, Trebilcock and Leng 2006). North argues that modern high technological complex economic relations are impossible without strong third-party contract enforcement (North 1990, p. 56-60). Given that by third-party enforcement he means ‘the development of the state as a coercive force able to monitor property rights and to enforce contracts effectively’ (North 1990, p. 59), many narrow his argument to refer to the paramount importance of public courts in modern economies (Deakin *et al.* 1994, p. 337, Kranton 1996, p. 832, Trebilcock and Leng 2006, Dietz 2012, p. 26).

To support the importance of public contract enforcement, proponents of this view compare the relative efficiency of public and private contract enforcement for the common welfare of society. For example, Posner, while agreeing that social norms do maximize the surplus produced by cooperative behaviour, proves that under some circumstances they fail to capture the higher advantage of cooperation which the state could have produced (Posner 1996, p. 1743).

Based on the proposition of socio-legal scholars that the most valuable effect of law concerns its indirect unspoken power to deter breaches of contracts – the so-called ‘shadow of the law’ (Macaulay 1977, Galanter 1981). Deakin, Lane and Wilkinson empirically confirm that contract law has an indirect implicit role as a ‘shadow’ for commercial practices which facilitates trust formation in business relationships (Deakin *et al.* 1994). A comparative empirical study of businesses in the UK, Germany and Italy by Arrighetti, Bachmann and Deakin conclude that the ‘rigidities’ of legal regulation along with professional regulation by trade associations have a positive effect in the long term (Arrighetti *et al.* 1997).

The substantive body of macro level empirical research employs subjective and objective indicators of contract enforcement and property rights security to provide significant support for the proposition that countries with developed legal institutions enjoy a better rate of economic development (Clague *et al.* 1999, Acemoglu *et al.* 2001, Djankov *et al.* 2003, La Porta *et al.* 2008).

Apart from highlighting the advantages of public ordering, its proponents identify the downsides of private contractual arrangements that might hamper the maximization of the surplus produced by cooperative behaviour. Such impediments were suggested to include entry barriers (Batjargal 2003, Oleinik 2004, Richman 2004), non-transparency and resistance to law (Oleinik 2004), enhanced opportunities for criminal involvement (Milhaupt and West 2000), and the possibility of collective collusion to undermine competition (Posner 1996, Hoskisson *et al.* 2000).

Finally, scholars such as Katz, take the view that whatever the utilitarian efficiency of private enforcement is, public enforcement has a superior value as it ‘offers processes and policies of greater legitimacy and fairness’ (Katz 2000, p. 2491-2494).

Attempts to overturn the hypothesis on importance of public contract enforcement comprise mostly empirical studies. Some scholars research private contract enforcement at the level of specific communities or industries in developed economies and conclude that it is a major *modus operandi* in these settings (Macaulay 1963, Ellickson 1991, Bernstein 1992, Woodruff 1998, Bernstein 2000, Richman 2004). They highlight the advantages of private ordering compared to public courts, such as efficiency, informality and the ultimate contribution to the public good. Yet these success stories regarding private ordering are limited to technologically unsophisticated industries and/or are confined to feasible

geographical localities – features which diverge from technological progress in modern globalized markets.

Others analyze the so-called ‘China Enigma’ and the ‘East Asian Miracle’ as two ‘non-standard’ deviations from the North proposition (Trebilcock and Leng 2006). They present distinct growth models that do not appear to support the centrality of the formal rule-based state enforcement of contracts in achieving strong economic outcomes. Yet it is undeniable that Chinese businesses rely on many third-party institutions that ensure contractual compliance, such as mediation, arbitration (Utter 1987) and intermediation by state officials in long-distance trade (Trebilcock and Leng 2006). Furthermore, the evidence on the marginal role of courts in the business relations of Chinese companies is inconclusive, as some studies document the growing demand for court services in China (Pei 2001).

More recent attempts to demonstrate the problems of state enforcement concern highly technological industries and cross-border trade. Business relations in innovation-based industries which are characterized by high complexity and uncertainty as to the outcome of exchange, entail specific investments, and require intensive knowledge transfer; accordingly they are particularly prone to opportunism. Likewise, long-distance trade tremendously increases the uncertainty of transactions and enhances the threat of opportunism.

An example of contract enforcement in Japanese high-tech industries was presented by Bardhan as a case where ‘the state loses some of its efficacy in guiding private sector coordination and relation-based systems delay active restructuring’; yet he admitted that in the early stages of industrial development the role of state institutions are still indispensable (Bardhan 2005, p. 518-519). Dietz showed in his empirical research of modern cross-

border software industry that ‘courts in the transnational realm are hardly able to generate a ‘shadow’ for complex business relations’ (Dietz 2012). However, other scholars disagree. Berkowitz, Moenus and Pistor, and Nunn – also based upon empirical research – claim that the quality of domestic legal institutions, including courts, are conducive to the export of complex goods (Berkowitz *et al.* 2004, Nunn 2007).

Thus it seems rather difficult to find conclusive arguments to downplay the role of courts in modern impersonal economic exchanges. At the same time, the studies surveyed above demonstrate that third-party enforcement may be effectively performed by other than the state enforcers – organized multilateral institutions such as:

credit cooperatives, credit card companies, consumer groups, escrow companies, trading companies, wholesalers, chain stores, hotel chains, banks, trade associations, unions, trading companies, trade and industry associations, stock exchanges, clearinghouses, credit rating agencies, credit bureaus, and better business bureaus and many others (Greif 2008, p. 744)

Alongside well-functioning public courts, these deliberately-designed private contract enforcement mechanisms are the ‘hallmark of advanced market economies’ most efficient in service and consumers’ goods sectors that fueled the growth of modern market economies (Greif 2008, p. 744). Business associations that facilitate the dissemination of reputational information were found to be crucial in supporting complex international innovative transactions in contemporary software industry, notwithstanding the ineffectiveness of public ordering (Dietz 2012).

To conclude, the literature surveyed above suggests that highly competitive markets and technologically complex industries inevitably require the support of credible third-party institutions – be it public courts, or private designed multilateral mechanisms. North himself stated that ‘complex contracting that would allow one to capture the gains from trade in a world of impersonal exchange must be accompanied by *some kind* of third-party

enforcement' (North 1990, p. 57). Therefore, it was found more fruitful for this research to attach equal analytical importance to private and public contract enforcement (Pistor 1996, Hendley *et al.* 2000, Menard 2000, Johnson *et al.* 2002, Macaulay 2003, Masten and Prufer 2011) and to keep an eye on any third-party mechanisms that might promote cooperation in contractual relations.

2.2 Relational Contracting

The second strand of literature from which my research has benefitted stems from the critique of contract theory in traditional legal studies and is referred to as relational contracting.

Contractual relations between business people regarding economic exchange are seen by scholars working on relational contracting as a complex phenomena characterized by an inherently contradictory nature. Contractual relationships were shown to experience tension between cooperation and competition (Burchell and Wilkinson 1997, p. 219); flexibility and control (Vlaar *et al.* 2007, p. 440), harmony and conflict (Macneil 1983, p. 353). Yet classic contract law in the civil and the common law traditions alike treated contracts quite restrictively.

In traditional common law textbooks, contract is defined as an exchange of promises for which, if breached, the law will provide a remedy (Barnett 1991). In Ukraine, representing a civil law tradition, contract is defined as 'an agreement of two or more parties aimed at establishment, change or termination of civil law rights and obligations' (Civil Code of Ukraine Article 626). Although there is quite a difference between these definitions they both are based on similar general assumptions.

Relational contracting scholars demonstrate that classic contract law takes for granted that a transaction under the contract is discrete, the identities of the parties are irrelevant, agreements and performance are clear and complete, issues of opportunism and of trust do not arise, the personal involvement of the parties is minimized, no significant histories nor likely future relations exist, and that if any problems occur they can be remedied by the application of the law (Macneil 1977, p. 856-857, Allen 2002, p. 257).

This traditional view of the contract dominated the legal world for centuries, but has been recently subject to challenge by socio-legal scholars. Goetz and Scott argue: ‘where the future contingencies are peculiarly intricate or uncertain, practical difficulties arise that impede the contracting parties’ efforts to allocate optimally all risks at the time of contracting’ (Goetz and Scott 1981, p. 1090). Classic contract law was critiqued for incapability to reflect the modern conditions of a technologically developed market economy.

As a consequence of the above critique, the socio-legal approach to contracts has firstly expanded the scope of the notion of contracts, and secondly helped scholars develop a contextual analysis of contracts.

In 1963 Macaulay published his seminal empirical study of non-contractual relations in business. He found that in business:

Disputes are frequently settled without reference to the contract or potential for 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 1963, p. 61)

Another scholar, Jan Macneil, used Macaulay’s ground-breaking study as a ‘demolition effort’ that cleared the way for a new contract theory (King and Smith 2009, p.

8). Later Macneil developed a theoretical vision of contract as a relationship and referred to it as a relational contract theory.

Relational contracting scholars came up with a view of contracting derived from empirical observations, which better reflected a messy reality and therefore did not fit conventional jurisprudential and legislative approaches to contracts. They advocated a highly contextual approach to understanding contractual relations (Macneil 2000, p. 881) and the importance of the wider economic, organizational and institutional environment in which the contract and its compliance are set (Deakin *et al.* 1994, Burchell and Wilkinson 1997, Allen 2002).

Within this wider approach, Macneil equated contracts to ‘relations among people who have exchanged, are exchanging, or expect to be exchanging in the future’ (Macneil 1987, p. 274). Consequently, contracting was viewed as a ‘process of managing and adjusting relationships within a framework set by formal agreements and other external regulatory influences’ (Deakin and Michie 1997, p. 124).

The relational perspective classifies contracts through a continuum ranging from highly discrete or transactional, to highly relational contracts (Macneil 1973, p. 738-40).

Discrete contracting, which occupies one extreme pole of the continuum, corresponds to the traditional assumptions of contract law. Relationships that fall under the extreme relational pole of the continuum are shown by Macaulay and Gordon to be akin to a marriage (Macaulay 1963, p. 65, Gordon 1985, p. 569); Leib compares them to friendships (Leib 2006). According to these scholars, relational contracting is characterized by long-term cooperation, the high personal involvement of the parties often leading to personal relations, and by enhanced cooperation in technical expertise and information sharing. The long-term orientation of both parties towards continued contracting for

indeterminate periods of time introduces an element of uncertainty into the relationship that is dealt with by flexibility in arrangements. Therefore, the substance of contractual obligations is often fluid and imprecise; consequently, written contracts, if signed at all, capture only a few aspects of the relationship. Finally, legal rights and law in general is believed to have a minor significance in relational contracting. According to Gordon:

In bad times the parties are expected to lend one another mutual support, rather than standing on their rights; each will treat the other's insistence on literal performance as wilful obstructionism . . . and the sanction for egregiously bad behaviour is always . . . refusal to deal again (Gordon 1985, p. 569).

Macneil's initial continuum differentiating between transactional (as-if-discrete) and relational contracting modes is expressly multidimensional. Alongside the formal characteristics of contracts such as duration and completeness, it incorporates various aspects of relations between trading partners such as expectations of future dealings and participants' views of transaction, as well as a few factors that are exogenous to the relationship (Macneil 1973, p. 738-40).

The initial discrete-relational continuum was subsequently modified, expanded or narrowed down depending upon the goals of research by many empirical studies across developed and developing economies, in law and other disciplines¹¹. For example, Sako and Campbell and Harris have introduced trust as one of the determinative characteristics of the relationality of contracts (Sako 1992, Campbell and Harris 1993).

Three other characteristics of the transaction at stake – uncertainty, the frequency of recurring transactions, and the degree of idiosyncratic investments – were found by the economist and organizational studies scholar Oliver Williamson to determine the hybrid

¹¹ For summary of empirical studies by legal and management scholars see King and Smith 2009.

forms of contractual governance, which are akin to the notion of relational contracting developed by Macneil (Williamson 1995, p. 30).

For the purposes of this research, and following the approach suggested by Crystal in the empirical study of discrete and relational contracts in US courts (Crystal 1988), this study treats as discrete the contracts with first-time and occasional one-off trading partners who have not yet established a stable relationship, and treats all others as relational, acknowledging that the relationality of these contracts may vary in quality and degree.

As in the contract enforcement literature, research in the broadly conceived relational contracting tradition advocates a contextual analysis of contractual relationships within wider societal environment consisting of multiple factors. Yet the selection of these environmental factors is not straightforward. Macaulay commented that the socio-legal approach does not ‘offer elegant models of contracting behaviour. You get a story and multiple factors to consider, but not a simple formula that produces results’ (Macaulay 2000, p. 783).

Responding to the need to contextualize business relations, most researchers have selected contextual or environmental factors based upon their subjective understandings and empirical findings. The number of environmental factors under examination tended to increase with the introduction of a multidisciplinary perspective. Sako, for example, has explored business relations within social and moral norms, technological and economic factors, corporate strategy and entrepreneurship (Sako 1992). Deakin, Lane and Wilkinson concentrated on the link between business relations and the available state of know-how and technology, the structure of relevant labour and product markets, the broader normative framework of laws and customs, and assumptions within which inter-firm relations are embedded (Deakin *et al.* 1994).

Most studies of contractual relations in business have differentiated between the wider business environment of a particular society evident in macroeconomic and political conditions, and a more specific environment that is characteristic of the businesses or industries under investigation. For example, Arrighetti et al. distinguished between sectoral and institutional levels (Arrighetti *et al.* 1997, p. 177); Sako separated technological and broadly market conditions (Sako 1992, p. 151). A similar approach aimed at differentiating between the various levels of the institutional environment surrounding the business relations was also employed by researchers of contract enforcement in the institutional tradition (Williamson 2000), discussed in section 2.1 above.

Following Burchell and Wilkinson, this study differentiates between the wider business environment and formal contractual frameworks within which personal contracts develop (Burchell and Wilkinson 1997, p. 223). For the purposes of this study the wider business environment encompasses macroeconomic factors such as the degree of the customization of production and the openness of market; and political factors such as the role of the state and its policies towards business. Given that researched companies in this study reflect the nationwide conditions of the Ukrainian market, the conventional sectoral factors of product customization and market openness are treated for the purposes of this research as characteristics of the wider business environment. Unlike studies that analyze courts as a component of the business environment (Arrighetti *et al.* 1997, Johnson *et al.* 2002, Akimova and Schwodiauer 2005), this study treats courts as a contract enforcement mechanism as such, and places them within the wider business context. Formal contracts that provide a common frame of reference in business and mediate between contract enforcement mechanisms and the broader business environment are analyzed in this study as comprising the immediate contractual environment of Ukrainian businesses.

2.3 Conclusions

This research relies primarily upon the logic of analysis offered by the contract enforcement perspective on contractual relations. The central object of investigation in this research comprises a complex system of contract enforcement mechanisms, referred to as a contractual pattern. Contract enforcement mechanisms of a varied nature are united by a common goal – the attainment of contractual compliance and the economic purpose of the exchange.

A review of the contract enforcement literature demonstrates that the integration of contractual arrangements of an inherently different nature within a single unified analytical framework is not an easy task. This study relied upon the least controversial (and most practical for empirical research) distinction between public and private contract enforcement.

Public mechanisms are presented by the state courts, private mechanisms embrace a divergent array of formal and informal devices – bilateral and multilateral, spontaneous and designed. Nevertheless this study attaches equal analytical importance to private and public contract enforcement mechanisms. Private mechanisms are undeniably the primary means of supporting contracts in any societal setting. Little regard to contract law and public courts by business people all over the world does not imply a similarity of informal, socially rooted mechanisms to support contracts in different societal settings. Furthermore, courts are seen in this study as important constituents of the contract enforcement system, as they not only resolve contractual disputes but also project the ‘shadow of the law’ onto genuinely private business-to-business relations, thereby complementing private contract enforcement.

Among private arrangements that support contracts, multilateral designed mechanisms which manifest themselves through trade associations, credit rating bureaus, permanent arbitration panels, and the like were demonstrated to be the most valuable for boosting market oriented impersonal trade.

Building this research upon the most reliable, albeit very basic, classification of contract enforcement mechanisms has a notable positive effect. It leaves open the possibility of constructing mechanisms from scratch, in the context of a particular society. Therefore, this study opts for an empirically driven contextual analysis of contract enforcement in contemporary post-Soviet Ukraine.

In building the premises for this study, the literature review suggests that another body of research – on relational contracting – could contribute to the contract enforcement perspective in a number of ways. First, insights from the relational contracting literature could facilitate the process of the analytical construction of contract enforcement mechanisms based on the empirical observations and analysis of individual transactions, written contracts and business relationships.

The second contribution of relational contracting scholarship which is of value for the purposes of this research relates to the acknowledgement of the inherently different nature of contracting relationships between new and unfamiliar trading partners, and between regular long-standing trading partners. Therefore, contracts with first-time trading partners are treated in this research as discrete (or as ‘if-discrete’ in Macneil’s terms), and all other contracts as relational with varied degrees of relationality.

Third, the relational contracting literature directs the researchers’ attention to the written contractual documents and suggests that their study contributes to a deeper understanding of contract enforcement relations in businesses. Written contracts are

capable of offering a dynamic perspective to contracting and shedding light on many contract enforcement mechanisms including prepayment, trade credits, discounts, technological cooperation, dispute resolution by courts, and others.

Finally, the contract enforcement and relational contracting literature highlights the importance of the socio-economic context of contractual relations. Having surveyed several approaches, this research distinguishes between the wider business environment (the level of uncertainties, the extent of market openness and the customization of production, and the role of the state in business), and the immediate contractual environment comprising formal contractual frameworks. Both levels of the business environment are discussed in the following chapters.

PART II BUSINESS ENVIRONMENT OF THE RESEARCHED COMPANIES

In order meaningfully to interpret the results of my empirical research, this part places contract enforcement mechanisms within the environmental context of contemporary Ukrainian business.

Chapter 3 is devoted to the analysis of the wider business environment. This chapter reveals that limited market openness paired with the negligible customization of production, high uncertainty and the predatory role of the state can result in a specific and uneasy business environment.

Chapter 4 examines the immediate environment of Ukrainian business constituting contractual frameworks. This chapter demonstrates that the overwhelming practice of formal written contracting, identified at the researched companies in line with previous research, operates as a shield against the uncertainties of the wider business environment.

CHAPTER 3 THE WIDER BUSINESS ENVIRONMENT IN UKRAINE

While an objective assessment of the quality of the wider business environment is far beyond the scope of this study, its perceptions by interviewees at the researched companies are crucial for understanding why businesses rely on some contract enforcement mechanisms more than on the others.

The overall quality of the business environment in Ukraine is repeatedly ranked very low by almost all international surveys. According to the 2012 World Bank ‘Doing Business Survey’, Ukraine ranked 152nd out of 183 economies, and 180th and 181st on the ease of obtaining construction permits and tax payments.¹² This chapter explores the deficiencies of the Ukrainian business environment through the eyes of the interviewees.

3.1 The Success and Failure of Institutional Reforms

Ukraine, with a population of around 50 million and the second largest economy within the former Soviet Union, was blessed with a well-developed industrial base, a relatively highly trained labour force and rich farmlands holding 40% of the world’s black earth agricultural land. It was considered to have the greatest potential among all the Soviet Republics.

In two decades of transition, Ukraine has generally succeeded in transforming itself into a market economy. It was recognized as a market economy by the European Union and the United States in 2006 (Aslund 2009, p. 5). Although the economy contracted severely following the breakup of the Soviet Union, it experienced relatively stable growth between

¹² 2012 World Bank ‘Doing Business Survey’ <http://www.doingbusiness.org>

2000 and 2008 of around 7% per annum, and returned to 5% GDP growth after the global economic crisis of 2008.¹³

Assessments of the outcomes of reforms are mixed. By the second decade of transition, all major institutions, or at least their blueprints which laid the foundation for a market economy, were put into place. The private sector comprised 80% of all enterprises; a new or radically changed administrative system had been established; the court system, including specialized commercial courts, was functioning; monetary, fiscal, and tax systems and the system for regulation of private enterprises and competition were set up. Institutional reforms were accompanied by massive legislative efforts including thousands of laws and bylaws: regulations, instructions and guidelines of the ministries and numerous state agencies, as well as presidential decrees (Protsyk 2004).

In the sphere of business relations, important reforms simplified the tax regime for small enterprises, decreased the tax burden, restricted financial inspections by one per year, and relieved the entry requirements and bureaucratic procedures for newly established businesses. The Ukrainian Parliament adopted a host of progressive laws, including for example the Law ‘On Joint Stock Companies’ amended in 2011,¹⁴ which was considered by most experts to be a major improvement in corporate governance.

Furthermore, by the end of the second decade of independence, Ukraine possessed a contract law system fitting for a market economy. Within the body of contract law two codes that came in force in 2004 occupy a paramount position – the Civil Code and the Commercial Code. Although the codes overlap in some areas of regulation, contradict one another in certain parts, and are being repeatedly changed (Shishkin and Drobyshev 2007),

¹³ Data and Statistics for Ukraine, World Bank Development Indicators
<http://go.worldbank.org/GPPNM8A3N0>

¹⁴ The Law of Ukraine No 514-IV ‘On Joint Stock Companies’ of 17 September 2008
<http://zakon.rada.gov.ua>

the provisions related to contractual relations among businesses are relatively well-designed and stable.

The basic ground rules constituting contract law are in place. Contracts must be respected; the freedom of contract is recognized; contract formation is based on the ‘mirror image’ rule which treats an attempt to accept the offer on different terms as a counteroffer (2004 Civil Code Chapter 52). In commercial contracts the fault of the party in breach is not required for the purposes of damages unless the *force majeure* is involved; the main remedies for contract breach include specific performance and damages; punitive damages are allowed; in the case where the contract does not specify contractual penalties, statutory default rules apply.

Generally, the quality of the law of contracts is seen as adequate by Ukrainian businesses. For example, the 2007 IFC survey confirmed that Ukrainian companies of all sizes are most satisfied with the legislation concerning relationships between suppliers and clients where about 50% of disputes fall (IFC 2007).

At the same time, it is impossible to overlook the shortcomings of the reforms. Although major institutions are in place, many of them are incomplete and inconsistent with each other (Tiffin 2006). The pace, cost and the general efficiency of institutional changes in Ukraine have been assessed as highly disappointing – nearly every institutional reform in all spheres of life was late (Aslund 2008, p. 155). The institutional reform took a very unbalanced path in Ukraine when the periods of rather rapid and concentrated reform efforts in certain sectors were replaced by stagnation and retreats.

While Ukraine’s mass privatization resulted in more than a 80% share of private enterprises, the state still holds majority shares in key sectors and subsidizes many unproductive enterprises, promoting rent seeking and ineffective management. The SME

sector remains very small compared even to Russia, let alone other countries of Eastern Europe (Smallbone and Welter 2001, p. 74). A massive legislative drive resulted in the overregulation of business and deregulation is one of the required steps. Tax regulation was named as the second most serious grave problem by Ukrainian businesses following corruption in the 2012 Global Competitiveness Report (Schwab 2012).

Although these examples do not offer a comprehensive picture of institutional reforms that were undertaken by Ukraine in its transition to market economy, they illustrate the partial success of these reforms in the area of business relations, which is the most relevant to the research of contract enforcement. Partial success of the market reforms and inadequate state policies, contributed to some of the factors influencing contract enforcement, such as weak competition and environmental uncertainties which are discussed below.

3.2 Market Openness and Product Customization

The competitiveness of markets and the prevailing technologies of production impact contract enforcement by determining the availability of alternative trading partners, as well as the degree of interdependence with existing trading partners. In respect to the selected Ukrainian companies – the Plant, the Farm and the Café – market openness and the customization of production reflected the general conditions intrinsic to the Ukrainian economy as a whole. Therefore, they are analyzed as constituting the wider environment of Ukrainian business.

Market Openness

The extent of market openness has been demonstrated by many studies to determine the course of action in repeated bilateral business interactions (Pyle 2006b, p. 29-30) and to influence the trust-building processes (Sako 1992, p. 19).

In closed markets, alternative trading partners are unavailable, either because the existing ones are monopolists on the market and alternatives simply do not exist, or because networks restrict new entry based on ethnic or other considerations, for example in close knit ethnic communities. In these types of markets, trading partners are deemed to cooperate with each other in an endless circle of unavoidable repeated dealings.

Consequently, in open markets where alternative trading partners are readily available, the high degree of customer turnover correlates with greater rates of litigation, since the cost of damaging a relationship through litigation is less if the search costs for new customers are comparatively low (Pyle 2006b).

The factor of market openness and the customer base was found to be crucial for the understanding of contract enforcement in the post-Soviet transition environment. Hendley explained the rather imperious and coercive contract enforcement performed by some of the researched Russian companies by the fact that these companies had a substantial pool of reliable customers and were unique suppliers to a few of them (Hendley 2001).

By the end of the second decade of transition, the Ukrainian market displays a moderate level of monopolization and openness. The limited evidence available from public sources paints a picture of two halves.

On the one hand, the Ukrainian national market could not be considered completely closed. In certain respects it proved to be more competitive than other East European countries. For example, in his comparative study of inter-firm cooperation in Ukraine and

Estonia, Czaban has found that Ukrainian enterprises were less mutually dependent on each other than Estonian ones:

The combination of market pressures and the stabilisation of the economy at a low level encouraged the reduction of suppliers' dependence on a single customer and the active search for new suppliers. Indeed, most senior managers of these companies claimed that they preferred multi-sourcing, though in practice they maintained a few 'preferred' suppliers (Czaban 2003, p. 18)

On the other hand, experts believe that market competition in Ukraine is not sufficient to induce sustained economic growth. The 2007 OECD study showed overall turnover rates in manufacturing to be rather low by OECD standards – about 10% in 2002-2005, compared with the rates of 15-20% typically found in mature market economies (OECD 2007). The same OECD study demonstrated that exit barriers in the Ukrainian market are more prohibitive than entrance barriers. Yet they could be seen as ultimate entry barriers since they prevent the release of production factors that might otherwise be available to new entrants.

According to Gianella and Tompson, market concentration is higher in Ukraine than in Russia in every major sector, and tends to rise in key export sectors, including metallurgy, chemicals, machine building and food (Gianella and Tompson 2007, p. 11). High levels of market concentration were believed to 'reflect the relatively large share of output that is generated in highly monopolised and unstructured network industries' (*ibid.* p.11).

The markets of the researched companies generally reflect the moderate level of competitiveness characteristic of Ukraine as a whole. As reflected by Table 4.1, the number of trading partners with which researched companies have business transactions within a calendar year ranges from 23 at the Café, 92 at the Farm to 400 at the Plant.

Table 4.1 Number of Trading Partners in 2009¹⁵

	Plant		Farm		Café	
	<i>Buyers</i>	<i>Suppliers</i>	<i>Buyers</i>	<i>Suppliers</i>	<i>Suppliers</i>	<i>Landlords</i>
Total number of trading partners	150	250	18	74	18	5
Of which were:						
a) first-time	9 (6%)	125 (50%)	8 (44%)	19 (26%)	2 (11%)	1 (20%)
b) repeated but not considered regular	6 (4%)	25 (10%)	1 (6%)	10 (13%)	2 (11%)	0
c) regular	135 (90%)	100 (40%)	9 (50%)	45 (61%)	14 (78%)	4 (80%)

According to the above table, every year each of the companies initiated contracts with new trading partners that constituted generally around one quarter of all partners. Most trading partners of the researched companies were reported to be replaceable within a period of two to fourteen days, while a minority of other trading partners was irreplaceable. For example, the Café treated all the five landlords as irreplaceable.

To compare these findings, Sako for example catalogued those companies which took more than eight months to replace their supplier as ‘constrained’ and the rest as ‘freewill’ (Sako 1992, p. 19). Thus most of the trading partners of the researched companies were ‘freewill’ companies in Sako’s terms. By this perspective, the markets of the researched companies could not be classified as completely closed.

At the same time, it should be borne in mind that the volume of trade with first-time unfamiliar contracting partners remained highly insignificant at the researched companies. More than 80% of their profits are received from transactions with regular long-standing

¹⁵ Source: Data drawn from author’s fieldwork.

partners. Furthermore, certain ‘new’ trading partners were in fact ‘old’ ones, because they were either restructured or re-registered under a new name.

Furthermore, while all the interviewees admitted the possibility of new trading partners entering their markets, they stressed that by the end of the 2010s they expect almost no new entrants. The perceptions of market openness by interviewees at all three companies were expressed through phrases such as: ‘Players at the market are all the same, they do not change’ [Sales Manager C, the Plant, interview on 3 September 2007]; ‘Our market is settled (*ustoyavshiyasya*), we do not expect any changes with the economic crisis’ [Farm Owner, interview on 26 July 2007].

Apart from being neither closed nor completely open, the Ukrainian market exhibited a noticeable buyer-seller asymmetry. According to Table 4.1, the number of suppliers sufficiently exceeded the number of buyers at both the Plant and the Farm. Suppliers’ markets were more competitive than those of buyers, therefore suppliers have to compete fiercely for so-called ‘live money’ (*zhivyye den’gi*).

A similar market asymmetry was noticed by Hendley in the context of Russian contract enforcement: ‘With most enterprises operating at far below capacity, goods are easily available, but many enterprises lack the liquid resources to pay for them’ (Hendley *et al.* 2000, p. 639).

Thus, while the closed nature of markets and extreme mutual dependence between trading partners can be considered irrelevant to the researched companies, the number of alternative trading partners remained low and the markets were perceived by the interviewees as semi-closed. Moderate competition existed in both the sellers’ as well as the buyers’ markets, although the suppliers’ markets were more competitive at all the companies.

Customization of Production

Customization of production is an important determinant of contract enforcement. Customer-specific investment makes the customer more vulnerable to the opportunistic behaviour of the supplier; in turn the supplier finds themselves tied to the only customer who is willing to pay for the customized goods. Thereby the customization of production creates a mutual dependency that predetermines both parties' choice of contract enforcement strategies towards long-term trustful relations (Williamson 2008). Modern industry, mainly in the information and communication sectors, increasingly relies upon technologically complex goods which are designed and produced for a specific customer (Dietz 2012, Hadfield and Bozovic 2012). A high level of customer-specific investments was shown to contribute to a better quality of goods and to be critically dependent upon reliable judicial system (Essaji and Fujiwara 2011).

All the post-Soviet countries inherited a Soviet standardized economic structure and a low level of production technology (Yegorov 2009). According to Czaban, production in the post-Soviet transition was characterized either by narrow or by very diverse product lines which have barely changed in the last ten years (Czaban 2003, p. 18). In post-Soviet Ukraine, the lack of resources prevented most of the large industrial enterprises from developing new product lines to suit the needs of specific customers. The niche to meet the specific demands of customers was slowly occupied by small innovative firms, while production at large enterprises remained largely standardized.

The findings of this research generally corroborate the low level of product customization in the markets of the researched companies.

The Café did not produce any goods itself, nor did its suppliers produce specifically for the Café, and the question of customization was therefore irrelevant.

The Plant and the Farm produced and sold highly standardized goods from their stock. They have not seriously contemplated any significant changes in their production lines to accommodate any specific requests of their clients.

The Plant reported only a few cases when it had to slightly adjust the specifications of its cable on the request of the customer, and these dated back to the Soviet times. As soon as the Plant adjusted its production for those few buyers, the relationships were cemented and terminated only with the bankruptcy of the buyer. Otherwise, trading partners exhibited a high degree of patience towards the faults of each other (for an example of customization arrangements dated back to the 1960s see the Case No 1.4 Ilitskiy Plant, Appendix 3). The new production line of the Plant, planned for installation in 2008, was aimed at increasing productivity and decreasing labour intensity, but not at customization.

The Farm was even less responsive to the possibility of producing specific crops for specific customers. Only once did the Farm Manager hear of a large foreign oil processor encouraging farmers to cultivate a specific variety of sunflowers. However, it was seen as troublesome, and the Farm remained with the safer option of standardized crops.

With regard to its suppliers, neither the Plant nor the Farm has had to invest in custom-made equipment on a regular basis, although a few one-off transactions were reported. For example, the Plant struggled to arrange supplies of inexpensive but important spare parts for its old Soviet machinery in 2007-2009. After the small private firm in Kiev failed to produce and supply them, the Plant turned to the Moscow producer that was able to manufacture the details under the Plant drawings, albeit at a higher price. Another example refers to the cable producing equipment for the new production workshop, which was produced by the Spanish company on request of the Plant. Customer-specific

investment apparently contributed to the patience of the Spanish producer which waited for the final payment from the Plant for more than three years.

The Farm reported a single case of product customization in 2007-2011. The supplier of agricultural machinery adjusted one of the trucks to fit the Farm's newly constructed storage facility.

Thus the degree of customization of production at the researched companies proved to be either zero at Café and negligible at the Plant and the Farm.

3.3 Political and Macroeconomic Uncertainties

The uncertainties of the wider business environment were shown by many contract enforcement studies to shape private contract enforcement, and ultimately impact upon the use of courts. Yet the precise outlook of contractual patterns under high environmental uncertainty remains clouded. Taking into account the fact that environmental uncertainties are different in different societal settings and that a host of factors other than environmental uncertainties influence the shape of contract enforcement, it is not surprising that empirical studies point in opposite directions.

On the one hand, uncertain prospects decrease the time limits for planning in business, and the relationships consequently concentrate on immediate gains to secure against uncertain future. Sako has suggested that the more uncertain the market demand facing the customer, the greater the proportion of suppliers with which it wishes to engage for short-term impersonal contractual dealings. And vice versa: the more rapid and steady the growth of demand, the more scope there is for long-term personalized relational contracting to develop (Sako 1992, p. 155-156). Hendley assumes that uncertainty, whether it results from increased sectoral competition or macroeconomic instability, undermines

bilateral norms that govern the relationship, and often increases litigation (Hendley 2004a, p. 305).

On the other hand, uncertainties prompt less formal arrangements in business, as the parties are unwilling to tie themselves formally to their trading partners. As suggested by Podolny who relied on transaction costs analysis, the higher the uncertainty of the future relations of the parties, the higher probability of an incomplete contract. Provided that the trust relationship between the parties has been established, informal continuous relationships could proliferate under high uncertainties of the institutional environment (Podolny 1994).

In the post-Soviet transition, environmental uncertainties naturally abound, therefore some researchers have predicted the rise of relational contracting and incomplete contracts (Gow *et al.* 2000). Pistor suggested that environmental uncertainties in post-Soviet Russia forced businesses to stick to ‘the narrow circle of friends, relatives and long-term trading partners, or bet on the advantages that a non-transparent market offers for opportunistic behaviour’ (Pistor 1996, p. 86).

Thus environmental uncertainties were found to decrease the time span of formal cooperation and to trigger the use of litigation. Yet uncertainties could also promote long-term cooperation and informal contractual arrangements between trading partners.

In order to understand the implication of environmental uncertainties for the contract enforcement pattern of Ukrainian companies, this section offers an overview of political and macroeconomic uncertainties in Ukraine, and then looks at these questions through the eyes of the researched companies.

Political instability was perhaps the major feature that characterized Ukraine during two decades of its transition. According to Protsyk, the semi-presidential model adopted by

Ukraine has led to endless confrontation between the president and prime ministers, a high rate of cabinet turnover and high levels of intra-executive conflicts (Protsyk 2003, p. 1092). The situation in Ukrainian politics was viewed by Gould and Hetman as ‘competitive authoritarian crises’ where the ‘combination of limited space for political contestation and illiberal regime practice’ lead to more regime crises (Gould and Hetman 2008, p. 27). After the significant advance toward democracy in the run-up to the 2004 Orange Revolution, Ukraine demonstrated a decline in all democracy ratings by 2012. The detention of opposition leader Yulia Tymoshenko in 2011 became a major obstacle on the way towards closer integration of Ukraine with the European Union (Severinsen 2012).

In a similar vein, since its independence in 1991, the macroeconomic situation in Ukraine was extremely unstable. The GDP inherited from the Soviet period began a rapid decline straight after the breakdown of the Soviet Union. Ukraine holds the world record for inflation in one calendar year, for 1993.

From 2000, Ukraine’s economy began to recover. According to Grigor’ev and his colleagues, increased competition, and an effective fiscal and monetary policy helped to reduce inflation rates; this, along with rising external demand for Ukrainian goods, made possible some economic growth in 2007-2008 (Grigor’ev *et al.* 2009). Yet this fragile growth was abruptly hit by the 2008 world economic crisis. After contracting by 15% in 2009, GDP slowly recovered by around 5% in 2011. The global financial crisis pushed the Ukrainian economy into a recession.

Although in both economic crises of 1998 and 2008 Ukraine managed to escape major financial disasters, the country balanced on the edge of default. Some experts are inclined to see Ukraine’s economic development as a series of crises that originated in the

deep recession of the Soviet economy, succeeded one another without a break and went far beyond the limits of ordinary economic cycles (Libanova 2010).

State policies across the different sectors of the economy were highly inconsistent throughout the period of transition. As remarked by Ukrainian sociologists Kutsenko and Golovakha, ‘no one can identify a coherent concept of economic policy in the activities of the Ukrainian government, and this has always been the case since Ukraine gained its independence’ (Kutsenko and Golovakha 2007, p. 71).

Agriculture presented a striking example in this regard. For about twenty years Ukraine struggled to introduce a private market in agricultural land, but the process was forestalled (Allina-Pisano 2004). In 2001, parliament passed the Land Code that provided for the private ownership of land and facilitated the privatization of land for agricultural purposes. However, it banned sales of agricultural land; this ban was in force during the whole period of my research. Although the farmers enjoyed tax breaks, minimum prices and import tariffs, they were ‘implicitly taxed by bureaucratic interference and insufficient liberalisation and investment in marketing and transport infrastructure’ (von Cramon-Taubadel *et al.* 2004, p. 1)

Furthermore, in its effort to respond to natural harvest fluctuations, to protect the internal agricultural market and to put food prices under control, the Ukrainian government introduced grain export quotas in 2006 on an *ad hoc* basis reviewable yearly. The quotas were reintroduced in 2008 and 2011. Needless to say, this measure substantially influenced demand and supply as well as the prices on the Ukrainian grain market. From the very beginning, experts criticized quotas as an unjustified and ill-advised measure to protect the poor in Ukraine. They were demonstrated to result in food consumers gaining very little, imposing large losses on grain producers, affecting export revenues, and contributing into

rent seeking and corruption by its non-transparency (Brummer *et al.* 2009). Taking into account the fact that Ukraine was the sixth largest wheat exporter in the world, export restrictions fell under major criticism on the international arena. As a result, discretionary policy interventions, which relied heavily on Soviet-style non-market administrative measures, have amplified the instability of agricultural markets.

The outcomes of the similar, inconsistent, non-transparent governmental regulatory policies were observable in most sectors of the Ukrainian economy. They contributed greatly to perceptions by Ukrainian and foreign businesses of the wider institutional environment as highly volatile (Salata 2011, p. 19).

To conclude, recurring political and economic crises made businesses feel accustomed to permanent uncertainty and locked Ukraine into a cyclical time frame with an extremely low horizon aiming at survival ‘from one harvest to the next, from one budget to the next’ (Pakhomov 2010, p. 26).

Uncertainties on the Ground: 2008 Economic Crisis

Until the world economic crisis of 2008 the three researched companies were relatively stable and profitable businesses. The 2008 crisis hit Ukraine in mid October and all three companies at once began to experience decline in demand for their goods. While due to the specifics of food sector, the Farm and the Café were able to quickly regain sales, the Plant turned out to be the only one that was not able to recover.

The story of the Plant’s struggle for survival in the aftermath of the 2008 crisis illustrates the various types of uncertainties of the Ukrainian business environment and their impact upon business. Although the global crisis reached Ukraine at the end of 2008, it was only two years later when the Plant began to notably decline and approach

bankruptcy. What seemed once to be a prosperous enterprise with a substantial growth in profits and a ten percent-share of the Ukrainian cable market, was crumbling.

By the end of the 2008, the Plant was falling deeper into a trap of non-payments. Because most of the Plant's buyers, such as construction companies and metal plants, largely stopped their operation in early 2009, the sales contracted three times. Many buyers simply stopped buying cable, and a few of them delayed their payments. Furthermore, most of the buyers became unable to prepay for their purchases, and the Plant had to offer them trade credit. Consequently, the Plant began to delay its payments to the suppliers. By the end of 2009, around 80% of payments under credit contracts were delayed to suppliers.

Mutual delays prompted the renegotiation of contracts. While previously the Plant's clients were prepaying, now it was the Plant which had to pay upfront for its main inputs. In January 2009 the payment of wages to the Plant's employees began to be regularly delayed, for the first time since the turbulent 1990s, and by 2011 the delay amounted to three months. However, the Plant's situation was not unique; many industrial enterprises in Ukraine were in the same situation.

There were other circumstances that brought the Plant to the edge of bankruptcy. Its modernization, that had been its main hope before 2008, became its misfortune. With minimal profits, the Plant was unable to repay the bank a loan, yet it decided to continue its modernization project. By early 2009 it was already half-way through – the Plant had built new premises and had partly prepaid German and Spanish suppliers for the equipment. The only hope for the Plant was to complete the modernization, to increase its productivity and beat the competitors on prices.

Yet by 2011 this hope became largely illusory. Constrained by a cash shortage, the Plant was unable to pay VAT on the equipment imported from Germany and the equipment

was seized at customs.¹⁶ Although the government owed the Plant unreturned VAT amounting to three months of sales, it refused to offset the VAT and release the equipment. Thus the Plant was not able to complete the modernization or improve its financial situation.

On top of this, because the equipment was stuck at customs, the Plant was fined by the tax inspectorate for unreturned foreign currency.¹⁷ The equipment had been prepaid by the Plant but not formally delivered to its premises. Therefore, it was considered a money laundering deal by the tax authorities. Within a year, the progressive fine reached around UAH 3,000,000 (US\$ 300,000), which was in excess of the contract price. The Plant was sued by the tax administration, and following the judgment began to repay the fine in instalments while the equipment was still held at customs. It was indeed a vicious circle.

The year 2009 finished with the sad result that the Plant had UAH 22,000,000 (US\$ 2,200,000) in losses and a 53% decrease in net income compared to 2008. It was a trap from which the Plant was barely able to escape. Yet by enormous efforts it was somehow drifting, managing to pay the fines to the tax administration and the interest on the loans, but delaying wages for its own employees.

However, this was not the end of the bitter story. According to my interviewees, the real disaster came from where nobody expected. They claimed that in 2010 the newly elected government of Yanukovich, with overwhelming electoral support and a stronghold in Donetsk, began an unofficial extortion campaign against businesses in Donetsk and

¹⁶ As reported by the interviewees in this study, the return of VAT was possible for 30% bribe in cash under Yuschenko government. After Yanukovitch came in power, the bribes supposedly rose up twice and made any VAT returns for the Plant impossible.

¹⁷ The Law of Ukraine No 185/94-VR 'On Payments in Foreign Currency' of 23 September 1994 <http://zakon.rada.gov.ua> It is aimed at restricting money-laundering practices and imposes progressive fine when the cross-border payment is not reciprocated within 90 days.

apparently in the whole of Ukraine. On top of all the disasters, this extortion campaign caused the Plant thousands, if not millions in fines.

By 2011 the owner of the Plant, who at that time was a Russian company, officially went into bankruptcy and the ownership was transferred to Russian bankers but no substantial changes occurred. When I left the Plant in early 2012, the employees were waiting for the bankruptcy to be officially announced.

It was not clear whether the speedy decline of the Plant into economic crisis was caused by mismanagement by the Russian owners or the local executive directors, by deliberate attempts at asset-stripping, or simply by bad luck. Yet it was obvious that it owed a lot to state extortion and the uncertainties of the business environment.

To sum up, it would not be an overstatement to conclude that in the second decade of the post-Soviet transition, the level of environmental uncertainty has increased in Ukraine. The interviewees in this study often remarked that ‘anything could happen in this country’ and suggested that it would be safer to be prepared for the worst-case scenarios of economic and political development. Ukraine’s integration into the world economy aggravated national political and economic instability. Yet the disruption caused by the 2008 global financial crisis was still seen by some businesses as to some extent fair (‘the whole world suffers’) and manageable. In contrast, the uncertainties and financial losses caused by the policies of the Ukrainian government were seen as capable of ruining any business and therefore more troublesome. Therefore the following section explores in more detail the role of the state in Ukrainian business.

3.4 The Role of the State

Studies of contract enforcement in developed economies have considered the influence of the state on contractual patterns in business mainly through the analysis of regulatory frameworks and the operation of courts. Apart from these commonly acknowledged influences, the post-Soviet transition environment presents an example of a direct and qualitatively different role of the state in business.

The rapid collapse of the Soviet system opened up unprecedented window of opportunities for individuals' rent-seeking aspirations – 'incentives to spend time and effort to divert, for their own uses, part of the surplus of market activities or to guard their shares of surplus against appropriate activities on the part of others' (Cheikbossian 2003, p. 272). Those who were entrenched for decades in the informal Soviet economy unsurprisingly seized the opportunity at the first onset. The underdeveloped institutional environment could offer very few constraints against these rent-seeking activities.

As a result, Ukraine, alongside Russia and a few other post-Soviet societies, approached the model of a rent-seeking society. In such societies, the state apparatus could be seen a major means to appropriate and redistribute wealth (Dubrovskiy *et al.* 2008) where the powers of the state and business converge uniquely (Chaisty 2008). While there is a disagreement in recent academic literature as to whether this convergence in Russia and Ukraine could be characterized as a capturing of the state by business (Hellman *et al.* 2003, Iwasaki 2007, Gould and Hetman 2008) or a capturing of business by the state (Hanson and Teague 2005, Yakovlev 2006), or even a bargaining and exchange model between politicians and business (Oleinik 2005, Ledyayev 2008, Frye and Iwasaki 2011), it is clear that the mixture is complex and deeply embedded in social relations. According to Oleinik, these relationships develop in both directions – property rights converge into

political power, and simultaneously political power transforms into property rights, resulting in the concept of power property (Oleinik 2005, p. 14-15).

Increasingly, researchers explore the adverse impact of state capture upon economies in transition. State capture was shown to open up a whole set of business opportunities to the administrative class of bureaucrats and private businesses, such as access to important business information and enhanced protection from other bureaucrats (Akimova and Schwodiauer 2005), licensing advantages (Hoskisson *et al.* 2000), state subsidies (McFaul 1995), governmental contracts, tax privileges, and other tangible benefits (Batjargal 2003, p. 540). Many bureaucrats have successfully established and managed their own businesses, although these are formally registered as owned by their close relatives. According to Ledyayev, 'for some, their official position becomes just an instrument in their business career' (Ledyayev 2008, p. 20).

While quantitative studies demonstrate that captor firms enjoyed more protection of their own property rights and exhibited a superior firm performance, capture adversely affects small business growth, results in weaker economic performance and reduced foreign direct investment (Jensen 2002, Hellman *et al.* 2003, Slinko *et al.* 2005, Yakovlev 2006). Initially the state-owned enterprises which inherited the network capital of the Soviet system were the main beneficiaries of state capture; later the newly created large private companies made a conscious choice towards state capture as a major competitive business strategy (Hellman *et al.* 2003, p. 751).

Thus in a rent-seeking society the state could be seen as a lucrative source of power, open for competition and manipulation by the private actors. This type of power was widely recognized by elites and ordinary people alike by coining the term administrative

resources – the ‘use of bureaucratic hierarchies and the material resources of public institutions’ to advance private gains (Allina-Pisano 2010, p. 374).

Although the term initially referred to political actors’ unofficial advancement of electoral gains, it was also stretched to encompass any sphere including the judicial system, economic production and exchange. For example, according to Kurkchian, ‘administrative resources are usually defined as a lever that is often applied high up in the judiciary, by politicians, officials and business managers’ (Kurkchian 2007, p. 80).

The nature of administrative resources was generally viewed as coercive and deductive. Allina-Pisano, who studied administrative resources within the recent electoral campaigns in Ukraine, demonstrated that in contrast to vote buying, administrative resources operate through threats to withdraw individuals’ and companies’ access to public goods such as salaries, public infrastructure, public education and markets in consumer goods (Allina-Pisano 2010, p. 374).

Administrative resources were shown to be invoked as a major weapon by private as well as state actors to attack the property rights of businesses through extortions and hostile takeovers – corporate raids (Volkov 2004, Markus 2012). In his research of Russian businesses, Gans-Morse documented that state officials were ‘increasingly initiating attacks on firms themselves rather than merely offering property security services to private actors’ (Gans-Morse 2011, p. 227).

Given the manipulative and often coercive nature of the administrative resources that characterizes the Ukrainian state apparatus as a whole, the profound institutional distrust of the state comes as no surprise (Mollering and Stache 2007). A low level of trust in governmental institutions was inherited from the Soviet system while tight interpersonal

networks of trust remained almost the only ‘social glue’ in conditions of profound uncertainty (Khodyakov 2007, p. 123).

Since Ukrainian independence, numerous public opinion surveys, including the World Value Survey, clearly documented the pervasiveness of distrust of the state and government in Ukraine and indicated further deterioration in this respect.¹⁸ The survey of trust in the government conducted by the agency of the Ukrainian Parliament in 2010-2011 confirmed that the mass media, armed forces and religious organisations remained trusted, while the President was rapidly losing societal trust. Institutional trust was generally shown by this survey and other surveys to be further deteriorating (Libanova 2010, LLI 2011). Commercial courts in Ukraine were continuously seen as a corrupt and distrusted institution. Low institutional trust was directly associated with the high levels of corruption and even higher levels of perception of this phenomenon by the public (Cabelkova and Hanousek 2004).

Societies where institutional constraints such as effective property rights and the legal system lag behind rent-seeking structures, and where institutional trust is low, were seen by the researchers as locked in a ‘low-level equilibrium trap’ of underdevelopment (Dorward *et al.* 2005) or ‘institutional traps’ (Polterovich 2001).

This seems to be the case for Ukraine after two decades of transition and the ways out of this deadlock remain debatable. For example, Aslund suggested that the progressive transformations in the incentive systems of current oligarchs were some of the reasons for the recent economic growth in Ukraine (Aslund 2005). However, Ukrainian expert Kuzio was much more sceptical about ‘the transformation of oligarchs from robber-baron capitalists to entrepreneurial businessmen’ (Kuzio 2005, p. 354). He believed that this

¹⁸ World Values Surveys <http://www.worldvaluessurvey.org>

process affected only a minority of Ukrainian oligarchs and the most powerful of them continued to rely on rent-seeking strategies (Kuzio 2005).

Others saw the source of possible democratic reforms in Ukraine's susceptibility to external shocks and international financial aid. According to Dubrovskiy and his colleagues, when external shocks such as financial crises hit a rent-seeking society, the authoritarian ruler begins to lose control over the rent seeking. Thus institutional reforms as the second best option become almost inevitable and may be carried out even without a public mandate or interest group pressure (Dubrovskiy *et al.* 2008).

The accounts above demonstrate the specific role of the state in respect to businesses in Ukraine which is characterized by the merger of political and economic interests and the open possibility of manipulations of the administrative resources of the state in order to extract rents from businesses or to threaten their property rights. This role of Ukrainian state is expected to impact on the way that businesses structure their relationships with each other.

The State through the Eyes of the Researched Companies: Bespredel

‘There remained only one bandit in this country – the state’

[Top Manager of the Construction Company, interview on 27 July 2007]

The predatory role of the Ukrainian state that evolved from academic literature on the post-Soviet transition has been corroborated by the empirical findings of this present study. It can be best comprehended through the concept of *bespredel* suggested by the interviewees in this study.

There is no adequate translation of this word into English; in the latest edition of the Ozhegov Russian Language Dictionary it is defined as an extreme degree of illegality and

disorder.¹⁹ As many other expressions that popularly characterize state and society in the former Soviet Union, the word came from criminal jargon of the late 1980s. Then it meant the fierce violation of the thieves' laws (*ponyatiya*) within the criminal community. After the breakup of the Soviet Union the word *bespredel* came into usage in conjunction with the state and its law enforcement agencies. By the end of 2011, relations between businesses and state authorities in Ukraine were referred to as complete *bespredel* (*polnyy bespredel*) and were characterized by the following features.

First, the state was seen by the interviewees as disintegrated. When I asked them a direct question about the role of the state in their business, all replied that in fact there was *no* state in Ukraine now:

Do we have a state? The state is a structure which you give your taxes to, but in our country the state only extorts [Head of the Legal Department, the Plant, interview on 21 December 2010]

The Café Owner simply stressed: 'No, we do not have a state'. The Head of the Plant's economic security complained that 'we have no vertical of power', apparently recalling Putin's version of the strong state.

Second, state disintegration was driven by its capture by businesses. The state presented an amorphous but threatening administrative resources to anyone who possessed enough power to capture it. The non-transparent system of grain quotas in agriculture and governmental 'cleansings' of the copper market were offered as examples of manipulations with administrative resources which benefited large business.

The example of the 'cleansing' of the copper market is particularly instructive as it also illustrates the high level of unpredictability of state policies. In November 2010 the

¹⁹ Ozhegov Dictionary <http://enc-dic.com/ozhegov/Bespredel-1584.html>

Plant faced a tax inspection that was clearly directed against certain suppliers of its copper.

The lawyers explained:

The whole market of copper in Ukraine is almost all black. There are only two legal producers of copper rod. Under Timoshenko the firms importing black copper rod proliferated. Now when Yanukovich came in power, they 'clean' the market. Those who have no governmental *krysha* (a cover) are being destroyed. The tax inspectorate initiated criminal charges against them. So they [the state] make the Plant buy from those few suppliers who have got a *krysha* and only through prepayment. If you buy under trade credit from those without a *krysha*, the tax inspectorate invalidates the contracts on 'public policy' grounds [Head of the Legal Department, the Plant, interview on 23 December 2010]

It was not clear whether this account by the Head of Legal was accurate, as I have not found any other supporting information. However it showed how private businesses could exploit administrative resources to their advantage.

A third feature characteristic of the state *bespredel* was extortion from businesses. Interviewees stressed that the state only 'skins' (*sdirayet shkuru*), 'extorts' (*vymogayet*), 'strangles' (*dushit*) and 'squeezes' (*vydavlivayet*). Extortions could take the form of attacks on property rights, 'voluntary' donations to state agencies or indirect regular tributes in the form of administrative fines.

The Café Owner experienced appropriation attacks by state officials on her property twice during the period of my fieldwork (Case No 3.4 Leisure Park, Case No 3.3 Kiosk, Appendix 3). In both cases, municipal authorities used the whole arsenal of intimidating inspections through law enforcement and regulatory agencies, outrageous fines, court litigation and criminal charges against her.

Donations to the construction of the city football stadium, the organization of conferences by the local tax administration, and the purchase of an automobile for the local governor were offered as examples of the 'voluntary' contributions that businesses were

asked to make. Only few businesses could afford to resist them. Taking into account the relatively insignificant value of the requests, it was easier to fulfil them without asking questions. Furthermore, the interviewees noted the declining use of this fundraising strategy by the local authorities.

The major method of state extortion comprised fines imposed upon businesses during regular intimidating inspections by the tax inspectorate and numerous other state agencies. Although Ukrainian law restricted the financial inspections of a business entity to one per year and required a minimum of ten days notice, which was seen as indeed a great relief for business, non-financial inspections by other agencies, such as fire safety, sanitation, occupational safety, and many others remained unrestricted. Most state agencies had at least two levels of organization – the city and the oblast (region). Therefore they could inspect businesses and impose fines at least twice for each matter. As the Head of the Plant's Legal Department remarked, 'they simply do not give us a chance to work'.

Implicit and explicit threats became part of the inspections. In some cases, tax inspectors were not able to justify the high amount of the fines that they were obliged to impose under their 'plan'. When the actual tax violations identified by the inspector were not sufficient to cover the amount of the 'planned' fine, the tax administration threatened even higher fines and criminal charges.

According to the interviewees, in these circumstances some businesses surrendered quickly – the owners simply destroyed certain accounting documents themselves so that the next morning the tax inspector documented the violation and calculated the required amount of fines. Others dared to resist and to sue the tax administration in the administrative court. One of the businesses successfully had a UAH 140,000 fine repealed through the administrative court and was immediately confronted with a second fine of

UAH 400,000 and threatened with a third fine of UAH 1,000,000. Within a year, all the three judgements were appealed in the appellate and high instance of the administrative courts, and eventually the fines were revoked, but this cost quite a lot.

Finally, state *bespredel* was characterized by the extreme arbitrariness and lack of the transparency of state actions towards businesses. In the face of incomprehensible and contradictory legislation, the logic of decision-making by the disintegrated state was completely unclear. The interviewees were not able to explain the rationale even behind certain positive decisions by the state agencies in their favour (Case No 3.4 Leisure Park, Case No 3.3 Kiosk, Appendix 3).

Informal rules governing unofficial relations between the businesses and local state authorities, namely the tax inspectorates, were reported to be in constant flux. The consensus amongst interviewees was that absolutely all businesses in Ukraine, except perhaps those that are foreign owned, were involved in tax evasion and could be subjected to fines relatively legitimately. Therefore, most Ukrainian businesses were reported to maintain ‘good relations’ with their tax inspectors and the heads of the local tax inspectorates who were regularly treated with the gifts in kind and in envelopes.

According to the respondents at all the three researched companies, before 2010 informal rules governing relations with tax inspectorates allowed for renegotiations and the decrease of fines, provided the bribe was paid in cash. After the new government came into power in 2011 the rules were unilaterally changed – all of a sudden, tax inspectors stopped accepting bribes, but instead demanded outrageously high fines to be paid to the state budgets; any negotiations to decrease these fines became fruitless.²⁰

²⁰ To feel the difference caused by this change of rules here are some numbers. In the result of 2009 tax inspection one unnamed business was threatened with a fine of UAH 58,000. Informal negotiations with the head of the local tax department resulted in UAH 10,000 paid to the budget and 8,000 in cash as a bribe. In

Moreover, relations with the tax inspectors were sometimes influenced by personal sympathies. The wrong treatment of the tax inspector and a graceless tone of conversation during the onsite inspection could cost the company under inspection huge fines, protracted litigation and criminal charges. Stories of this kind abound.

To sum up, Ukrainian businesses characterise the state as *bespredel* – an unrestricted administrative resources that could be used to extort rent from businesses. Both the state budget and bureaucrats' private pockets benefited from such extortion. While administrative resources in Russia are concentrated under presidential power and at least appear more controlled, in Ukraine the state was seen as disintegrated and open to capture by any powerful business for their advantage. Official and unofficial state regulatory policies and extortion exhibited a high level of arbitrariness, non-transparency, and violence towards businesses. Finally, the informal rules of the game with the state authorities were in constant and unpredictable flux. All of this increased the general perception of the business environment in Ukraine as extremely uncertain.

3.5 Conclusions

This chapter first offered a general introduction into institutional reforms in Ukraine after it gained its independence in 1991. It revealed a mixed picture of success. Although by the time of this research Ukraine possessed basic institutions to support a market economy, many of them were incomplete and contradictory. While in certain areas, such as the

2010, after the elections and the change of the heads of the local tax inspectorates, the fine imposed upon this business raised to UAH 87,000 paid to the state budget and no bribes accepted to decrease this fine. In 2011 the informal link was restored and the company ended up with only 80,000 in fines, while others had to contribute almost twice as much.

contract law, the rules proved to be relatively stable; changes in taxation, judicial and administrative systems were never-ending.

Having identified a moderate success in Ukraine's economic and administrative reforms, this chapter focused on the factors that were found by researchers in developed economies to influence the contractual patterns of business – the openness of markets, product customization and the uncertainties of the business environment.

The Ukrainian business environment inherited from the Soviet economy displayed moderate, if not weak, competition, with buyer-seller asymmetry and a negligible level of product customization. In respect to these factors, the markets of the researched companies exhibited similar characteristics to the Ukrainian business environment on a nationwide level. While low product customization is expected to decrease the researched companies' reliance on repeated long-term interactions weak competition can increase such dependence.

The uncertainty of the wider business environment is another important factor anticipated to shape contract enforcement by shortening the transaction time of businesses and undermining long-term business ties. The institutional environment of Ukrainian business in the second decade of transition was strongly characterized as unstable and uncertain. Frequent changes of government, the associated political turbulence and discretionary policy interventions in business were amplified by the 2008 global financial crisis. It has doubled the uncertainties of the post-Soviet transition and in particular adversely impacted the Plant and its contractual practices.

Among the various kinds of uncertainties, those caused by the state itself through its official and unofficial policies, the threat to property rights and extortion were seen as the most problematic by the interviewees because they had the potential to ruin the businesses.

My literature review revealed that post-Soviet states adopt a rent-seeking model, where state power is captured by oligarchic clans and large businesses at the expense of others. Interviewees in this research conceptualized Ukrainian the state as *bespredel* – an unlimited, illegal and violent power. A comprehensive appreciation of the *bespredel* phenomenon is beyond the scope of this thesis; many horror stories of state extortion have been left out. The examples presented in this chapter were meant to illustrate the perceptions of hostility of the state towards Ukrainian businesses.

According to the interviewees in this study, the *bespredel* of state power was evident from the disintegration of the state into separate agencies, groups, and clans; the capture of the state by business; the arbitrariness and unpredictability of state policies; extortions from businesses in the form of appropriations, ‘voluntary’ donations to the state agencies, and more commonly fines imposed by the tax and other administrative authorities. All three researched companies regularly suffered from the *bespredel* of the state authorities.

Thus the predatory role of the state is expected to influence the contract-enforcement patterns of the researched companies indirectly through the increasing general level of environmental uncertainty, and directly through the promotion of specific contract enforcement practices.

At the same time, the idea that state involvement in business completely ruined the everyday life of businesses is misleading. While contacts with the state agencies were most painful and threatening for businesses they were fortunately fewer than any other daily encounters. Within the unfavourable conditions of the wider institutional environment, Ukrainian businesses continued to cooperate and develop. The good news was that they were able to shield themselves from most of the negative influences of the wider

institutional environment, including state *bespredel*. Struggling to create their own ‘state-free’ environment which was subject to more comprehensible and transparent – albeit informal – rules, businesses relied upon formal contractual frameworks and private contract enforcement mechanisms. These frameworks and mechanisms are examined in the following chapters.

CHAPTER 4 FORMAL CONTRACTS IN BUSINESS OF THE RESEARCHED COMPANIES

In order to understand how contract enforcement mechanisms operate, the previous chapter placed them within the context of the wider business environment for Ukrainian companies. This chapter explores the role of contracts in business relationships as constituting the immediate business environment which cushions the adverse impact of the wider environment, and bridges the gap between this environment and contract enforcement practices.

Contractual documents reflect some contract enforcement mechanisms such as enforcement through courts, prepayment, trade credit, quality assurance, technical cooperation, and are silent in respect to others such as reputation and repeated dealings. Yet by setting the parameters of economic exchange, contractual documents constitute the heart of any business relationship and are the starting point for an exploration of contract enforcement.

This chapter analyses the formal characteristics of written contracts at the researched companies, the patterns of signing contractual documents and the actual functions of the contracts. It shows that an understanding of the ‘non-legal’ functions of contracts unravels the rationale behind seemingly wasteful efforts at signing contracts where enforcement through the courts is pointless.

4.1 Nature and Role of Contracts in Business

No economic exchange could be carried out without an explicit or at least an implicit contract – the ‘meeting of minds’ of the parties. The question of the role of a contract in supporting economic exchange has become one of the most controversial issues in socio-

legal literature. In very general terms this debate was termed as ‘fundamental disagreement in the literature on the relationship between trust and control’ (Lane 1998, p. 25). It was largely triggered by contradictory empirical evidence.

Earlier empirical research downplayed the role of contracts in business relationships. Macaulay found in 1963 that businesses did not often resort to formal contracts; nor had they planned their contractual relationship in full, or used legal sanctions to enforce contracts and settle disputes (Macaulay 1963). Beale and Dugdale confirmed Macaulay’s findings in 1975 (Beale and Dugdale 1975). Palay noted in 1985 that ‘parties who have, or anticipate, strong relational ties with their contracting opposites are not particularly worried about initial terms of agreement’ (Palay 1985, p. 562). Formal contracts were seen as substitutes to trust in business relations by Lyons and Mehta (Lyons and Mehta 1997). Macaulay reiterated in 2003 that in many business relationships ‘careful contract negotiation signals distrust when the situation calls for a business marriage’ (Macaulay 2003, p. 46).

The other stream of empirical studies explored the role of contract in long-term relationships. Deakin and others contended that ‘a formal, detailed agreement may be a sign of a pre-existing cooperative relationship between the parties, which facilitates a process of advance planning’ (Deakin *et al.* 1994, p. 340). Arrighetti and colleagues empirically studied contracting practices of UK, German and Italian firms in mining machinery and furniture manufacturing (Arrighetti *et al.* 1997). Others explored contractual relations of US firms in varied sectors (Hadfield and Bozovic 2012); contracts for information services (Poppo and Zenger 2002); inter-firm relationships in technical innovation (Woolthuis *et al.* 2005). These studies confirmed the importance of the formal

written contract in business, as well as its complementary role in respect to trust and informal institutions of contract enforcement.

Increasingly researchers recognize various circumstances under which contracts could be of less or more importance. The findings of Woolthuis and colleagues distinguish between two scenarios. Where trust is lacking, the legal sanctions of a formal contract are seen as a viable substitution, provided the court system functions properly to draw meaningful redress; then ‘contracts are more likely to be intended and interpreted as safeguards against opportunism’. Where trust between contracting parties is in place the contract is not dismissed, but supports the relationship (Woolthuis *et al.* 2005).

The existence of numerous empirical findings pointing in opposite directions implies that the very notion of contract is ambiguous. If the contract is treated as an exclusively legal instrument for the purpose of litigation, then its role in business becomes marginal. According to Campbell:

If the legal remedy is not pursued when it is available, then the contract itself is not of the first importance. One does not need a contract to exchange goods – one needs the contract to get a state-underwritten guarantee of a remedy in the event of a breach (Campbell and Harris 1993, p. 168-169).

This approach that confines contracts to a ‘uni-dimensional legal safeguarding instrument’ was demonstrated to be misleading at best (Woolthuis *et al.* 2005, p. 834). Conversely, when other extra-legal functions of contracts are appreciated, the role of the contract in business relations becomes more meaningful. Apart from a legal recourse, contracts have been shown by many socio-legal scholars to be necessary for a variety of purposes.

First, all the contracts to various degrees incorporate the parties’ vision and planning of their commercial engagement. According to Vincent-Jones, the planning

function of the contract refers to technical issues of ‘determining who is to do what, when, and for how much, how payment is to be adjusted in line with task changes, and how performance is to be measured, monitored and rewarded’ (Vincent-Jones 2000, p. 325). Macaulay in his 1963 essay when describing the planning function of contract meant ‘careful provision for as many future contingencies as can be foreseen’ (Macaulay 1963, p. 56). Many researchers have empirically demonstrated that by spending more time on the negotiation of the technical details of their future deal, businesspeople think more of the coordination of their efforts in the case of unforeseen contingencies, such as technical or economic developments, a hostile takeover or the bankruptcy of one of their trading partners or accidents, rather than of possible opportunism and protective legal remedies (Macaulay 1963, p. 157, Beale and Dugdale 1975, Arrighetti *et al.* 1997, p. 185, Woolthuis *et al.* 2005, p. 835).

Second, where transactions are complex, formal contracts serve as a record of the deal and as a memory aid, akin to minutes of a meeting (Woolthuis *et al.* 2005, p. 831). Even in fairly simple transactions such as between businesses in Ghana, firms keep records of transactions and use them to ‘minimise discussion on the reality of the debt rather than to ensure payment through legal recourse’ (Fafchamps 1996, p. 441).

Third, contractual frameworks may be closely linked to the organizational routine of the companies concerned. In the context of a study of inter-firm alliances, Vlaar and others found that formalization may be ‘imposed on participants by the managers that are held responsible for the performance of the alliance’ (Vlaar *et al.* 2007, p. 441). According to Smith, contracts in many cases become formalized routine solutions to common problems of organizations which are established ‘without much thought to concerns about opportunism’ (King and Smith 2009, p. 31).

Fourth, in all types of contractual relations, contracts could perform a symbolic function to demonstrate a mutual belonging to the same community of people tied by common norms and a common cultural background (Woolthuis *et al.* 2005, p. 835). In this view, contracts represent ‘a symbolic gesture of legitimacy’ and ‘a symbolic rite of passage into the modern world of corporate business’ (King and Smith 2009, p. 39).

Finally, in long-term relations between regular trading partners, contracts could be treated as a sign of commitment to the relationship that signals loyalty and trust to the other party (Woolthuis *et al.* 2005, p. 831); as a communication tool to transmit information within and between firms (Roxenhall and Ghauri 2004, p. 267, Dietz 2012, p. 39); as a device to communicate legitimacy to a broader set of stakeholders, reinforce or establish organizational identity (King and Smith 2009, p. 33); as a basis for insurance coverage, a credit grant, the determination of a tax liability, or as legitimization of the actions of a company’s management vis-à-vis its owners (Dietz 2012, p. 38).

To conclude, this brief literature overview suggests that one productive way to look at formal contracts is to appreciate the qualitatively different functions of a contract which go far beyond a legal defence in courts.

Contracts in the Post-Soviet Transition

The transition from planned to market economies accompanied by an inevitable uncertainty, affects the role of contracts with some of its functions having a different emphasis, and others being completely different from those identified in the context of the developed economies. However scarce is the research on business contracts in the post-Soviet transition, it is an acknowledged fact that most businesses in this environment use written contracts.

The frequent use of written contracts was reported in all quantitative surveys of Ukrainian business. The 2007 IFC survey reported that 87.3% of companies of all sizes surveyed in the three regions of Ukraine had written contract in the last dispute (IFC 2007). In the Naschekina and Timoshenkov survey, 56% of the small businesses claimed to rely more on formally written documents than on informal agreements (Nashchekina and Timoshenkov 2002). These figures are similar to or higher than, for example, those documented in Uganda (16,6%) (Ntayi *et al.* 2012) or even in developed economies like Germany (65%), Britain (40%) and Italy (63%) (Arrighetti *et al.* 1997).

At the same time, researchers confirmed the common wisdom that contracts play a marginal role in post-Soviet business. Hendley suggested that ‘the reasons for this had little to do with the inadequacies of contract law or fears of being unable to enforce court judgments’ (Hendley 2009a, p. 40). She demonstrated that a resort to written contracts by Russian businesses is motivated by the aspiration to figure out the credit worthiness of a potential trading partner. Before the contracts are signed, businesses required the prospective counterparty to produce a number of documents to prove their credit worthiness. Although this method was never completely satisfactory it still provided some contractual certainty.

The function of contracts specific to the post-Soviet transition, it has been suggested, could be related to the practice of tax evasion and requirements of tax law (Kautonen *et al.* 2004). Vinogradova has mentioned that contracts in Russian small business ‘rarely reveal the full truth about a transaction’ and are legally required as ‘an account of transactions for taxation purposes’ (Vinogradova 2005, p. 79). Earlier researchers of the contract enforcement in the post-Soviet transition reported that:

In many cases, the official contract is but a cover-up document for a more detailed unofficial contract that may not even exist in writing. Dual-

contracts are widespread as a means to evade taxes, to hide certain aspects of transactions from the principals of the deal, or to allow middlemen to take a substantial cut (Pistor 1996, p. 29).

Thus the following sections explore in detail these and other functions of formal contracts in Ukrainian business and their implications for contract enforcement in Ukrainian business. To better address this task, the next section looks at the formal characteristics of the contracts typical of the researched companies.

4.2 Formal Contracting at the Researched Companies

4.2.1 Characteristics of Formal Contracts

Contract as a Written Document

Although Ukrainian law requires written contracts for all non-spot transactions between legal entities, this rule has many exceptions. Current Ukrainian Civil and Commercial Codes treat contracts in a more flexible way compared to Soviet standards. They recognise the freedom of contracts, allow contracts between businesses to be signed through an exchange of letters or another means of communication, and by acceptance of orders. Deficiencies of written form are not treated as critical. They do not automatically render the contract invalid, but only bar the party from using oral testimony to prove the contract in courts. Thus oral contracts are enforceable in courts if there is documentary evidence to support them. However, the popular perception of contracts has remained unchanged since Soviet times.

The contract was seen by interviewees only and exclusively as a single written document signed by both parties and sealed with the stamps of the both enterprises. All other exchanges of written documents such as letters were clearly perceived as oral agreements or transactions ‘without a contract’. Even where a single document was

transmitted by fax, the parties made efforts to exchange the hard copies with original signatures and a stamp called a 'wet seal' (*mokraya pechat'*) at a later date.

Where transactions were carried out 'without a contract' they were still accompanied by a number of written evidences such as invoices, bank statements, and most importantly various receipts – taxation receipts (*nalogovaya nakladnaya*), consignment notes (*tovarno-transportnaya nakladnaya – TTN*), or a goods receipt (*raskhodnaya nakladnaya*). Thus it was virtually impossible to have a non-cash transaction completely oral and off-the-books. Yet the above documents were seen by the interviewees as supportive of the contract; and the contract always meant a single document in writing.

In line with previous research, such written contracts in the form of a single document were prevalent in business dealings of the researched companies. Absolutely 100% of the Plant's contracts with its buyers and suppliers were written.

The majority of the Farm's contracts were written as well. I was not able to identify written contracts in three out of 57 transactions of sales by the Farm in 2009. The Farm Owner referred to this fact as an accidental omission. In contrast, supply transactions lacked written contracts in the Farm's files to a greater degree, in around 32% of all transactions. As clarified by the Farm Owner, these transactions were of minor monetary value with longstanding trustworthy suppliers.

As for the Café, the Café Owner claimed that all her suppliers necessarily sign contracts with her at the beginning of each year. However, I was able to get hold of written contracts for only five out of eighteen suppliers, and six contracts involving the rent of trading space and equipment. Owing to the nature of cash dealings, which are easier to conceal for taxation purposes, the cash sector of Ukrainian retail business remains largely in the shadow (Williams 2009). Therefore, I suspect that although all suppliers could have

signed written framework contracts with the Café Owner, a substantial number of transactions were carried out off-the-record without specifications or other documentary evidence, but I was not able to verify the scale of this practice.

While the actual usage of written contracts at the researched companies was not absolute, all the interviewees demonstrated a striking unanimity in endorsing the importance of formal writing. As they put it:

Contract is a protocol of intentions. We can work only with the contract [Head of the Supply Department, the Plant, interview on 28 October 2008]

The contract confirms the agreement. Even if we have personal relationship we still need a contract [Sales Manager B, the Plant, interview on 3 September 2007]

Yes, we need contracts albeit for a conditional defence in courts, [Farm Owner, interview on 17 October 2008]

I have an interest in contracts. For example, if I did not have a contract with Coca Cola they would not have changed the outdated goods or could have disrupted the supply. It is safer with the contract [Café Owner, interview on 18 October 2008]

Furthermore, the interviewees at the Farm and the Café felt embarrassed when I occasionally identified certain transactions missing a formal contract. They insisted that contracts should be signed in all cases.

Thus more than 80% of transactions of the Plant and the Farm²¹ were covered by written contractual documents. Although most relationships with the Café's suppliers were also conducted under the framework of a written contract, many transactions with these suppliers were off-the-record. Additionally, all the interviewees expressed their preference towards a written contract in business relations. Thus it could be concluded that a written contract was signed in the majority of transactions of the researched companies.

²¹ 100% of transactions with the buyers and the sellers at the Plant, 95% of the Farm's transactions with its buyers, and 68% of its transactions with suppliers.

One-shot and Framework Contracts

Apart from conventional arrangements where contractual arrangement for one transaction is reflected in one document, many written contracts of the researched companies were signed as framework contracts.

Framework contracts as used in Ukrainian business are made in writing but consist of two parts.²² The first part – the master agreement – includes all the terms required for the contract, except those few that could change during the life of contract and therefore could require renegotiation – the terms on price, quantity, mode of payment, and sometimes on quality and delivery. These highly contingent terms are called specifications, sometimes additional agreements. They are negotiated and signed by both parties independently of the master agreement, often much later than the master agreement. However, by their reference in the master agreement, specifications become a crucial part of the contract. Thus one master agreement may be appended by many specifications (as many as forty at the Plant).

Framework contracts common in contemporary Ukrainian business bear some resemblance to their counterparts in developed economies, such as blanket orders (Hendley 2009a, p. 14), umbrella contracts (Mouzas and Furmston 2008), and open terms contracts (Gergen 1992). However, Ukrainian framework contracts are different. Under the law and in perceptions of the interviewees in this study, a master agreement lacking specifications is clearly *not* binding under the law and in the perceptions of the interviewees here.

A framework contract proved to be an extremely flexible device. It allowed players to negotiate the terms that are essential for business at any time without negotiating the rest of the contract that remains ‘in stone’. Furthermore, depending on the needs of the parties, a framework contract could be used for a single transaction (a master agreement with one

²² A similar pattern of annual contracts was documented by Hendley in Russian business (Hendley 2001, p. 24).

specification) or for a number of recurring transactions (a master agreement with numerous specifications of several various dates).

Based on the data drawn from author's fieldwork, almost 96% of the Plan's contracts and 43% of the Farm's contracts were of a framework type. The Café's supply contracts could only be of a framework type, taking into account the fact that the Farm Owner reported signing contracts with her vendors only once a year. Therefore, 78% of the Café's contracts were of framework type. Thus on average a framework type of contracting was used in more than 70% of contracts at the researched companies.

Completeness of Contracts

The broad view on completeness of contracts recognizes that all contracts are incomplete to some degree as 'agents find it difficult and expensive to foresee all possible contingencies [...] especially when outcomes are unobservable or non-verifiable by a third party' (Gow *et al.* 2000, p. 2).

Unlike this broad approach, this current research follows the suggestion of Menard, who specified certain minimal variables of adaptation in respect to which the degree of completeness of contracts could be identified. Such variables include contractual terms on price, quality, quantities, delays, and penalties (Menard 2000, p. 7). As Ukrainian law makes the identity of goods an essential term of contract, it was also included into the analysis of contracts' completeness at the researched companies.

In pursuing the task of identifying the general degree of the contracts' completeness, two types of incompleteness could be distinguished: the vagueness of the term and its total omission. The vagueness of the term is the wording that does not allow to grasp the precise will of the parties, for example, the payment term that obliges the buyer to pay 'when it can' (Fafchamps 1996, p. 432) or a reference to broad standards such as 'good

faith’, ‘duties of cooperation’, or ‘within limits set by commercial reasonableness’ (Macaulay 2003, p. 44).

After having surveyed the contracts of the researched companies, it became clear that the parties tried to exclude vague language from their contracts. Only one contract reviewed in this study described the consulting services rendered to the Farm as ‘qualified [skilled] services’. In a few other contracts of the Farm and the Café, the wording of the clauses on penalties was incorrect, demonstrating the drafters’ legal ignorance. However, in the majority of reviewed contracts the clauses were either clearly spelled out or omitted as a whole.

The contracts, which omitted important contractual terms, were not numerous. After having reviewed the Plant’s contracts and specifications for 2009 it became clear that they were 100% complete with regards to the goods/services identity, price, quality, quantity, delivery, payment and penalties for contract-breach. This figure of complete contracts owed a lot to a rigorous procedure of contract approval which mandated the screening of all the draft contracts by the Plant’s lawyers, as well as other employees. Around 5% of the trading partners signed the Plant’s standard contractual documents, developed by the Legal Department, without minor change. In most other cases the Plant’s standard contracts were modified slightly with respect to delivery and payment terms. Thus it is quite safe to conclude that the absolute majority of the Plant’s contracts included all the basic terms of transactions albeit fixed in several documents – the master agreement and specifications.

The Farm’s contracts presented the greatest diversity in respect to the completeness. Based on the data drawn from author’s fieldwork, at least 70% of the Farm’s contracts with buyers and suppliers contained complete and unambiguous contractual terms. The remaining one third of contracts lacked various terms to differing degrees. The contracts

were most complete with regards to the payment terms and the least complete with regards to the delivery terms. Consequently, and as confirmed by the interviewees, payment was the most important to them. The terms on penalties for contract breach were the second most complete, along with the quantity and goods identity.²³

The Café's five contracts with suppliers, which I managed to examine, contained all the required express and unambiguous terms, except terms on the goods' identity, their price and quantity. These terms were claimed by the Café Owner to be contained in specifications which I was not able to obtain.

Taken together, the analysis of written contracts at the Plant and the Farm reveal a high degree of completeness in respect to their basic contractual terms. At the same time, the completeness of the Café's contracts was likely, but was not proven by well-supported evidence.

Contract Duration

In general the duration of the formal written contracts at the three researched companies did not exceed twelve months. The majority of contracts, including framework agreements, envisaged that transactions would be carried out solely within the current calendar year. Even the Café owner was quite certain that she signed all the contracts with her suppliers once a year, every year.

Despite the twelve-months duration fixed in the formal contracts, transactions in fact took much shorter to fulfil. Taking into account the fact that most of the transactions were direct purchase and a bank transfer to any part of Ukraine took from two to five hours, contracts and specifications were negotiated and executed almost instantly.

²³ Having reviewed the Farm's contracts for 2009 I found that the percentage of the contracts lacking the following terms were: delivery 29%; quality 21%; price 14%; quantity 7%; penalties 7%; goods or services identity 8%; payment 3%.

It took the Plant from one to five days to negotiate the specification and to initiate delivery. The Plant apparently felt pressure to decrease the duration of transactions as one of its strategic goals outlined in the 2015 Strategic Plan of Development was to decrease the time for contract authorization to eight hours and the time for loading the transport with cable to one hour.

The Farm's dealings were even speedier than those at the Plant. Around 75% of the Farm's sales and supply contracts were negotiated and initiated the same or the next day. For example of the deal that took a few hours see the Case No 2.7 Urgent Purchase of Chemicals, Appendix 3.

The Café ordered goods a few days in advance of the supply and paid for them in cash on the spot upon delivery, which characterized her dealings as the spot market.

Thus the formal duration of the contracts of three researched companies was found to be generally up to twelve months. Except the services and the rent contracts, which were very few, the actual contract duration of majority of contracts ranged from a few hours to a few weeks. Based upon these findings, it is safe to conclude that the contracts of the researched companies fall within a range of short-term contracts.

To sum up this brief overview of formal characteristics of contracts at the researched companies, a contract was treated as such by the interviewees in this study only when it was in the form of a single written document signed and sealed by both parties. The analysis of contractual terms reveals the preference for short-term written contractual arrangements in the form of framework agreements, fairly complete with regards to the basic terms.

This sounds like a very rigid and inflexible arrangement distinctive of the discrete impersonal mode of contracting, discussed in Chapter 2 of this thesis. However, in reality it exhibited a high level of flexibility. Seemingly identical contractual documents could attend both discrete and relational types of contracting. They could be used for a single transaction with the unfamiliar buyer who most likely will not return, as well as for the long-term relationship with the trusted trading partner. If combined, a two-day complete contract may reveal years of fruitful and cheerful cooperation between the parties.

Owing to the properties of formal contracts, researchers of the post-Soviet transition have little chance to infer actual business relationships from contractual documents alone. Therefore, apart from the form and content of formal contracts, the inquiry into everyday contracting practices is a logical step to understand the role of contracts in Ukraine.

4.2.2 Contract Signing Patterns

The Plant: Rigid Organizational Routine

The Plant had an essential flow of incoming and outgoing contractual documents, an elaborate procedure for contract signing and the authorization of transactions, and a sophisticated computerized system of contract monitoring.

The computerized system was being introduced as I began my research in 2007 and since that time has been continuously improved. In a simplified way it may be described as follows. Every incoming draft contract had to be scanned by the sales or supply manager. From this moment it was transformed into an electronic document which was transmitted between the departments in seconds. Each contract or specification went through up to seven stages of approvals. Before the Director took the pen in his hand and put an actual signature under the contract, it must have had virtual signatures of at least five people: the

Vice-Director for Economic Security, the head of the department which supervised the transaction, The Vice-Director for Economic and Financial Matters, the Lawyer, and the Chief Accountant. Despite the use of the computerized system, hard copies of the contracts with the original signatures of the parties were kept at the Legal Department.

Thus the system was built on and around written contracts. In theory it was largely impossible that the deal was authorized and initiated without a written contract and its screening in such a system. In practice it was possible but only under the order of one person: the Director. Lawyers estimated that around one fifth of the contracts missed legal scrutiny and got signed by the Director bypassing the Legal Department. Around 5% of the Plant's contracts were signed at the Plant's standard contract form without any changes whatsoever and therefore required no legal screening but still had to be approved by the rest of the departments.

Approved and signed contracts were mailed to trading partners by regular mail or handled to them in person and were expected to be returned in the same way. Where the trading partners were located outside the physical reach of the Plant's managers, faxed copies of the contracts were acceptable for the purposes of the initiation of the transaction, but originals were required at a later stage. As a rule, they were handled through truck drivers along with the goods.

Despite the obvious virtues of certainty and control that such a system provided, it was quite clumsy at times. The lawyers complained that they needed contracts or at least specifications for every tiny thing such as floor cloth and nails. Furthermore, the Head of the Legal Department was frequently concerned that it took too much time for some employees to approve their part of the draft contracts.

After the contracts were signed, essential contract terms such as price, delivery and payment dates were extracted from the contracts and stored in the managers' computer databases to monitor the transactions, while the paper contracts collected dust on the shelves of the Legal Department.

The Farm: Instant Transactions and Post Factum Contract Signing

In contrast to the Plant with its rigid and formalistic approach to contract authorization, the Farm had a more hectic negotiation and contract drafting pattern. Owing to the specifics of the agricultural market, the Farm was at the forefront of speedy deals:

We sell sunflower seeds through one click within five minutes because the prices change very quickly. It is gambling. The Manager brings a written note to the elevator where our seeds are stored, and they change the owner without any other documents [Farm Owner, interview on 2 December 2009]

The same pressure for time was evident in the Farm's relations with the most suppliers, when the spare details or chemicals were required urgently and the deals took hours.

Therefore, the Farm's internal procedures in respect to contract drafting and signing were simple as they coordinated only a few persons – the Manager, the Owner of the Farm, and occasionally the nominal Director. It was the secretary who kept the templates of the contracts in her computer and printed them out when required. Legal screening of the contracts was done by the Farm Owner who had a law degree. Yet, when he was absent, and frequently so, the Manager or the secretary herself read the draft contracts. Moreover, as a rule, the Farm Owner did not screen the contracts with the regular trading partners. Thus many contracts went through unscreened legally.

The Farm's internal procedures did not require written contracts to be signed in order to authorize the transaction. Yet the hard copies of all contracts signed in a calendar

year were stored in a folder and registered in computer database that contained the names of the parties, price and payment contractual terms.

This study has identified that a substantial number of the Farm's contracts were signed with the trading partners *post factum*. As conceded by the Farm Owner, at least half of the Farm's prepaid sales contracts were signed after the deals had been fully or partly executed. The contract negotiation procedure in this case was reported to be the following:

We are always in a hurry. First, we call the seller, discuss and agree on quantity, price, and prepayment. Second, we fax them an invoice. Third, they pay without signing a contract. Fourth, we load the trucks and sign the consignment note. A bit later we do other documents and sign the contract. So, the whole procedure may take from one to five days [Farm Owner, interview on 2 December 2009]

While it was absolutely safe for the Farm to sign contracts *post factum* when its buyers prepaid their purchase, *post factum* contracts were reported even in credit transactions with the buyers. Provided the buyer was a longstanding and trustworthy trading partner, the title in goods was transferred to the buyer prior to the payment and signing the contract. As explained by the Farm Owner, this practice was justified by logistical convenience. For example, he remarked in respect to one of the oldest trading partners, international food producer Cargill, that:

There is no problem with Cargill signing the contract first, but it is a hassle for us to go to see them twice – first for contract, then for the note to the elevator. It is practically and logistically easier for us to see them once [Farm Owner, interview on 2 December 2009]

The practice of the *post factum* contracting was not easy to uncover at the Farm because most of the Farm's transactions were very speedy anyway. The interviewees did not perceive contracts signed shortly after the payment had been initiated to be actually *post factum*. They were rather seen as one of the procedural steps in the transaction where the sequence of procedural steps did not make a difference.

The Café: Rubbish and Unenforceable Contracts

The Café Owner reported that she had written contracts with all of her landlords and most of her suppliers. Her contracts with all the suppliers without a single exception were signed as the standard contracts offered by suppliers and were almost never negotiated.

When I did the first interviews with the Café Owner in 2008 she reported quite a positive attitude towards written contracts. However, to my surprise, I subsequently discovered that neither the Café Owner nor her employees retained the originals or the copies of most contracts she had signed. The Café Owner actually threw all her contracts with the suppliers into the rubbish bin, never read them, let alone used them in her dealings with suppliers, even in the case of problems. A few types of contracts that the Owner kept were contracts of land rent with the City Council and the contracts for the lease of equipment with suppliers.

Moreover, the Café Owner considered the fact that she did not store her contracts properly as somehow shameful and as losing face. It took me a long time to uncover this practice. Every time I asked her to show me the actual contracts, she refused and made up various excuses. She sent me to her employees saying that they might have some contracts, and the employees sent me back to the Café Owner.

Finally, when I suspected that she may not have the copies of the contracts at all, I told her again about my research. I told her that socio-legal scholars long ago discovered and acknowledged the fact that businesses disregarded written contracts, and that this was extremely interesting for me. And only then she conceded that she did not store or read the contracts with her suppliers. In fact, these were the suppliers who needed the contracts.

Nevertheless, I still managed to get a hold of five supply contracts before they were sent to the rubbish bin, and I obtained a few others through the sales representatives of the suppliers. After having analyzed these contracts, another puzzle emerged.

The framework contracts that suppliers signed with the Café Owner turned out to be legally unenforceable, or at least very problematically enforceable. Four out of the five supply contracts reviewed in this study incorporated by reference to the essential contract terms contained in the receipts (*tovarnaya nakladnaya*) for each transaction. Furthermore, the reference to receipts in the contracts was reported to be a general practice in cash retail trade. However, Ukrainian courts do not treat receipts as parts of the contracts, but rather as evidence of contracts at best. Where the large suppliers, such as Biola and Coca Cola, thanks to their in-house counsel, were aware of this legal trap, they signed separate specifications with the precise list of goods and their prices. Yet the majority of the others seemed to be either unaware or indifferent about this problem.

Thus the Café Owner turned out to disregard written contracts with her suppliers and these were suppliers who cared about signing the contracts every year, yet these contracts turned out to be problematically enforceable in courts.

To conclude, the varied uses of contractual documents by the researched companies beg the question: Why does anyone need a contract to buy a floor cloth? What is the sense at all in signing a contract after the deal is executed? Why bother to sign legally unenforceable contracts when they are not required and then throw them into the rubbish bin? I suggest that the functions of contracts illuminate the hidden rationale behind the use of written documents and the link between this practice and contract enforcement mechanisms.

4.2.3 Functions of Formal Contracts

Contract Enforcement through the Courts

The conventionally assumed function of contracts as a legal recourse through the courts was recalled by the interviewees in this study in the first place as something off the top of their minds, yet the importance of this function of contracts was marginal. As the interviewees explained:

Only with the contract we can work. And it is the contract that we can go to court with. ... There is always some probability of court action, we have it in mind [Head of the Supply Department, the Plant, interview on 28 October 2008]

The contract is first of all for ourselves, and then for court, but court is not the first [Sales Manager C, the Plant, interview on 12 November 2008]

In principle one can apply to courts based on the contract, but in most cases we use it as the document for ourselves [Café Owner, interview on 4 November 2008]

Thus the court enforcement of rights and duties specified in the written contract was never the primary objective of the parties. Yet the interviewees did not exclude the possibility of contract enforcement through the courts.

Contracts as Managerial Routine

The use of written contract as ‘an organizing tool’ (Macaulay 1963, p. 60) or as ‘formalized routine solutions’ (King and Smith 2009, p. 31) proved to be the strongest motivational factor for written contracts for many Ukrainian enterprises. Their internal corporate guidelines often mandated written contracts as an unavoidable bureaucracy to serve logistical purposes. Much of the contractual routine at the ex-Soviet enterprises, including the Plant, originated in the requirements of strict written contracting imposed by the Soviet planned economy. The routine was, of course changed and adjusted to market economy and

modern technologies. For example, this study documented that the Soviet-style practice of signing contracts through the protocols of disagreements, evidenced by Hendley at large Russian enterprises in the end of 90-ies (Hendley *et al.* 1999, p. 843-847), has completely vanished from the practice of the researched Ukrainian companies and was reported to be non-existent in contemporary Ukrainian business. Instead, the contracts were negotiated orally until the final unified draft of the document was ready to be signed. Furthermore, computer technologies have tremendously eased the process of contract authorization and monitoring.

The Plant was the most constrained by its organizational routine. Generally speaking, not a single non-cash transaction of any amount could be authorized by the Plant without a written contract or at least without a specification. Conversely, the Farm and the Café were free of fetters of their own organizational bureaucracy. Instead, it was their trading partners who were often obliged by their corporate guidelines to sign contracts. At the end of the day the result was the same – most transactions were covered by written contracts at all the three researched companies. Thus the incorporation of written contracts into the organizational routine of many Ukrainian companies partly explains the overwhelming written contracting in Ukrainian business.

Contracts as Response to Taxation Regulations

Another powerful explanation of the preference for written contracts was offered by recognition of the impact of taxation and accounting regulations upon the contractual practices of the researched companies.

First, contracts were reported by the interviewees in this study to be required as part of the application to have VAT returned from the government. Among the three researched companies, it was only the Plant that dealt with VAT tax returns.

Second, contracts contained information which was crucial for accountants of the both contracting parties, but was meaningful for the purposes of economic exchange. Absolutely all contracts reviewed in this study included information on the status of the parties as taxpayers, which was extremely important to know for accountants in order correctly to reflect the transaction in their books. The three companies in this study presented three different regimes of taxation. The Plant was the payer of the income tax, the Farm of the single agricultural tax, and the Café Owner of the simplified single tax for small business. The trading partners of the researched companies represented a whole variety of taxation regimes. Thus contracts served as channels for transmission of this vital information.

Third, although the contracts were not the primary focus of tax inspectors during their regular raids at the enterprises, they had the right to look at any documents. According to the Farm Owner, ‘they [the tax inspectors] are crawling everywhere’ and if they have identified any faults in accounting documents they often check the selected contracts. At the Plant tax inspectors always screened all the export contracts in search for outdated debts that could be qualified as money laundering; and did selective checks of other types of contracts. Therefore, it was considered safer to keep contractual documentation in order, ‘just in case’ of tax inspections.

Thus taxation law turned out to be a forceful motivation for written contracts at all the researched companies. Even where the law did not expressly mandate written contracts, the researched companies felt safer with written contracts filed accurately in separate folders.

‘Technical’ Contracts as Cover for Tax Evasion

In some cases, contracts were signed with the sole purpose that they served as accounting documents. This research identified a substantial group of the so-called ‘technical’ contracts comprising 11% and 19% of the Farm’s and the Plant’s contracts respectively. These were feigned contracts used for the purposes of tax evasion which neither of the companies attempted to deny. Some methods of tax evasions were so trivial and formally legal that they were openly explained by interviewees and referred to as the tax optimization.

The Plant routinely signed absolutely legal but ‘technical’ contracts of storage of the cable, prepaid by customers. They were unnecessary in light of relations between the parties, however they made a difference for accounting purposes. The Farm’s ‘technical’ contracts comprised contracts of financial aid to and from selected trading partners and employees and occasionally a few sales of non-existent goods. The Café’s transactions were accompanied either by contracts and all necessary documentation, or were completely of-the-record. Thus ‘technical’ contracts were not used in this business.

The ‘technical’ contracts identified at the Plant and the Farm were just pieces of paper. Neither economic exchange nor any relations between the parties underlie these contracts. They were never negotiated and treated as accounting documents rather than contracts. Although the practice of tax evasion is an important area of relations between the state and business, it had no meaningful implications for business-to-business contract enforcement. Therefore, the analysis of contractual relations in this study excluded ‘technical’ contracts.

Contracts as Information Channel and Network Building Tool

In a number of contractual relationships in this study, formal contracts served as an information and networking tool to build up the customer base. As mentioned above, contracts communicated important information about the status of contracting partners as tax payers.

Contracts were resorted to by the researched companies as information channels to provide contact information on existing and new trading partners in order to update client data bases. Contracts were used in this capacity by the Plant and the Farm, but not by the Café. Instead it was the Café's suppliers – vendors – who relied upon written contracts as a network-building tool. Ukrainian retail business with a rapid turnover of retailers was the most dependent upon networking. Although reported to be in decline, the practice of abandoning companies and the registration of new ones at the same premises was still widespread in the retail sector. As remarked by the Café's supplier, it was often the case when 'the people were the same while the signboard changed'. Therefore, despite the fact that the contracts between the vendors and the Café Owner contained an automatic extension of the contract for a year, the Café's vendors preferred to sign contracts anew in the beginning of each year in order to update their databases of retailers.

Finally, on a few occasions, the contracts were used to engage new customers and to plan future operations without actual transactions in mind. The Plant and the Farm reported the limited practice of signing only the master part of the framework contracts where prospective cooperation was uncertain. Framework contracts lacking essential terms on quantities and price of the goods were clearly perceived by the parties as nonbinding declarations of intentions. Neither were they treated as binding by Ukrainian contract law.

A similar practice was identified by Hendley in her study of contractual relations in Russia (Hendley 2009a, p. 11-12).

Thus written contracts were universally used in Ukrainian business as information channels, and in some cases as network building tools.

Contracts as Recording Tool

Contracts in this study were also seen by the interviewees as a memory aid used to monitor the transaction. According to the interviewees, written contracts ‘described basic terms of cooperation’; ‘provided information, reminded some details’, and served as ‘evidence of the dealing in relations between us and suppliers’. In this view, contracts were seen as documents ‘for ourselves’ and became the first reference point in the case of problematic contractual performance.

At the same time, given the straightforwardness of most transactions of the researched companies in this study, the recording function of the contracts was limited to the basic contractual terms which were not hard to memorize. Therefore, after the contracts were signed, they were almost never opened unless contractual problem arose. As the Sales Manager of the Plant explained:

I do look into contracts very rarely. As I draft all contracts myself, I remember them well. Mine are almost all the same – the payment term is prepayment, the delivery term is self-delivery (*samovyvoz*). I open the contract only to get its number and the number of the clause on liability when the client has violated its obligations under the contract and I write the letters to them [Sales Manager C, the Plant, interview on 9 November 2008]

Contract as Planning Tool

The planning function of the contracts concerns practical steps to coordinate the transactions rather than legal recourse in the case of problems (Macaulay 1963, p. 56, Arrighetti *et al.* 1997, p. 185, Vincent-Jones 2000, p. 325, Woolthuis *et al.* 2005, p. 835).

The planning function of contracts at the researched companies turned out to be quite limited. It was confined to the basic arrangements with respect to the mode of payment, delivery and inspection of goods. Contracts were generally complete in respect to these basic terms.

At the same time, contracts avoided planning for joint efforts beyond immediate transactions such as expert advice, information sharing or joint personnel training. Given the low level of the customization of production, the researched companies did not require the above services from their trading partners. Limited informational sharing in respect to technological issues was confined to informal communication within business networks.

Even the firms which develop innovative products for specific customers were reported to avoid formalizing their cooperation in written documents. For example, the owner of the small innovation company which specialized in the design and production of industrial equipment and used to be a Plant's supplier explained that they train their buyers how to install and use their equipment unofficially:

We do not write about training in the contracts, in many cases we do it for free. In other cases the client may pay in-kind. For example, the client bought five pieces of equipment; we come and teach their workers and take back one out of five pieces back as a payment for training [Owner of the Small Innovation Firm, the Plant's Supplier, interview on 13 October 2011]

Where long-term investments were required from the customer to develop customer-specific equipment, most of arrangements of this small innovation company were done informally. As explained by the owner, cooperation was based upon personal contacts:

We have very good relations with one customer with whom we jointly design the equipment. Design may take a year and then another year to certify the equipment. Therefore, the Main Engineer of that customer says: 'Do it quickly while I am still alive to use my contacts and help you'

[Owner of the Small Innovation Firm, the Plant's Supplier, interview on 13 October 2011]

Thus this study documented that planning for extended technical cooperation was not included in the contracts of the researched companies.

Similarly, contingencies found their place in the contracts quite rarely. Where contingencies were foreseeable in real life, the parties preferred to ignore them in written contracts in order to leave themselves room for renegotiation. For example, the most frequent contingency in the Ukrainian transition environment is connected with the unexpected rise of prices of petroleum and raw materials that in turn leads to a price rise in end products. Yet the researched companies negotiated all price rises orally for each transaction, instead of including precise a long-term mechanism to deal with this contingency into their contracts.

The Farm was the most susceptible to uncertainties of various kinds; nevertheless its contracts did not include any 'saviour' clauses. When, for example, the quality of the Farm's grains was unclear or deteriorated, the Farm warned its buyers about possible problems and urged them to take samples for examination before committing to the contract. These procedures were negotiated orally and were not reflected in the contracts.

Instead, most contracts (100% of the Plant's contracts, 58% of the Farm's contracts and 100% of the reviewed supply contracts of the Café) contained a hardship or *force majeure* clause.²⁴ The presence of such a clause in the contract would have indicated its long-term orientation.

However, hardship clauses turned out to be a 'dead' contractual term. Neither of the interviewees has ever heard that these clauses had been enforced. The *force majeure*

²⁴ *Force majeure* clauses exclude the liability caused by unforeseen circumstances beyond a party's control. Under Ukrainian law, *force majeure* clauses could only be enforced through courts, and require a burdensome evidence procedure.

clauses were borrowed from the practice of cross-border trade and do not make much sense in a domestic context. According to the interviewees, they were included into the contracts without much thought, simply for the appearance of the contract.

Thus such a function of the written contract as the planning of bilateral relationships was substantially limited to basic contractual terms without much elaboration on future contingencies or any reference to technical cooperation, and did not stretch beyond current transaction.

Symbolic Function of Contracts

A symbolic function for contracts was also noticeable in the contracting practices of the researched companies. Given the straightforwardness of the transactions, all the necessary clauses could be expressed in a few paragraphs. Yet the parties consciously enlarged the text of their formal contracts by including a wealth of unnecessary clauses. Some of them were just the repetition of the wording of the Civil Code. Others, such as *force majeure* clauses, which were always the longest and the most elaborate clauses in the contracts, were of no practical use. This was apparently explained by the desire to attach more formal weight to the contracts, to make them look more sophisticated, and according to the interviewees more respectable (*solidnyy*).

The symbolism of Ukrainian contracts was not connected to the procedure of negotiation and the signing of contracts with the final handshake of the parties, as this was often absent. Most routine contracts were negotiated via telephone and passed to each other through secretaries or drivers so that the parties could not see each other. Instead, the fact of the signing of the contract was important as such. Two folders containing the contracts with the buyers and suppliers, accurately stored in chronological order and accompanied by the registry, were seen as an essential attribute of any business. Apparently, this enhanced

the sense of order and control over their own business within the uncertain wider environment.

To conclude this section on the functions of contracts in Ukrainian business, this study confirms that contract enforcement through the courts was neither excluded by the parties at the stage of contract signing nor represented the main purpose of written contracting. Apart from this conventional legal function of the contract, this study revealed other functions of contracts such as being the part of managerial routine, a cover for tax evasion, a response to requirements of taxation regulations or a network building tool, which were more powerful motivators of written contracting than the prospects of court action against the possible opportunism of the trading partner.

4.3 Conclusions

The findings described in this chapter confirm the prevalence of written contracts in Ukrainian business. More than 80% of the Plant's and the Farm's transactions were accompanied by written contracts. The Café also had written contracts with all her suppliers and landowners, but many transactions with them were off-the-record, confirming the informal nature of cash-operated small business in contemporary Ukraine (Williams 2009).

The contracts typical of the researched companies and their counterparties were signed in the form of a single document with the signatures and seals of both parties for a short-time duration – not exceeding twelve months. Around 70% of written contracts were signed in the form of framework agreements with one master agreement and appended specifications which were both required for the contract to be binding. Given the short-term

duration of contracts and their straightforward nature, most contracts were relatively complete and included unambiguous clauses with regards to the identity of goods, their price, quality, quantity, delays, penalties and dispute resolution, albeit often in different documents – main contracts and specifications. At the same time, all reviewed contracts avoided planning for joint cooperation or for future contingencies. This type of written contracting was used equally in relationships with first-time as well as regular trading partners.

Behind the general characteristics of formal contracts, this study identified their various socio-legal functions that helped to explain the preference for written contracting in Ukrainian business. Generally, the functions turned out to be quite similar to those identified in developed economies, but the emphases were noticeably different.

Written contracting as a part of a managerial routine turned out to be one of the most important functions of Ukrainian contracts and a powerful incentive for written contracting. The process of authorization and the monitoring of transactions at the Plant, and many trading partners of the Farm and the Café, was built on and around contracts. It was impossible in such a system to initiate a transaction without a written contract, or at least a specification containing basic contractual terms. While contract law did not require written contracts for each and every single transaction, managerial logic aiming at the minimization of processing costs mandated written contracts for all transactions, whether to arrange the supply of important inputs worth of thousands of dollars, or to buy a floor cloth for the cleaners.

Having its origins in the Soviet planned economy, the managerial routine of many Ukrainian enterprises was enhanced by the requirements of taxation and accounting law. Contracts provided each party with valuable information on the status of the counterparty

as a tax payer, required to account the transaction correctly. Contracts between trading parties were submitted to governmental agencies as a part of the application for a VAT rebate. A similar need to have written contracts as a basis for tax liability was identified by Dietz in contemporary cross-border software transactions (Dietz 2012).

However, the influence of the Ukrainian taxation requirements and the tax control system on contractual practices spread much further than imposing formal requirements. Written contracts were employed as a shield against unofficial extortions by tax inspectorates and other agencies. Although tax inspectors primarily checked accounting documents, in case of doubt they had a right to survey contracts. In the quest to escape the fines imposed by tax inspections, the companies created so-called ‘technical contracts’. These contracts were drafted solely for the tax inspection to legitimize tax evasion practices without transactions actually having taken place. Around 11% and 19% of the Farm’s and the Plant’s contracts were ‘technical’ and therefore excluded from analysis of contractual relations in the following chapters.

Apart from the influence of the tax law, written contracting was also motivated by the possibility of enforcement through courts, yet it was not of primary importance to the interviewees in this study. They treated written contracts as the documents ‘for themselves’ and only lastly ‘for the court’. Thus, in line with the recent studies of Russian business, courts and contract law were found neither written off nor expressly relied upon in contracting practices of the researched Ukrainian companies (Hendley 2009a).

Finally, given the short-term and straightforward nature of most buyer-seller transactions of the researched companies, contracts played only marginal role as recording and planning tools and were limited to the basic contractual arrangements. They did not concern technical cooperation, expertise and information sharing, joint personnel training

or possible contingencies. Where the time spans of transactions were substantial and transactions required serious cooperation, such as for example in innovation business, most arrangements were made informally and bypassed written contracts. Finally, the communication of contact details and accounting data between contracting parties through written contracts in order to maintain client databases was a useful, but secondary, function of contracts at large enterprises and in the retail trade sector.

Apart from the functions of the contracts expressly reported by the interviewees in this study, the symbolic function of contracts emerged as well. However, the symbolism of the Ukrainian contracts did not concern the process of contractual negotiation or the acceptance of newcomers into business networks. The symbolic function of Ukrainian contracts rather enhanced the businesses' sense of order and control over their own private sphere of economic life within an adverse and uncertain business environment.

Thus managerial routine, taxation regulations and the prospect of the court enforcement of contracts were found to be the primary reasons for the overwhelming preference for written contracting in Ukrainian business.

The Plant was the most sensitive to taxation requirements and the most likely to make it to courts among the three researched companies. Therefore, its managerial routine has incorporated written contracts screened by lawyers and made them an absolute 'must' for transactions to be initiated.

The Farm as a payer of simplified agricultural tax was released from the substantial part of taxation scrutiny by the authorities. Furthermore, owing to its modest size, managerial routine did not play an enhanced role at the Farm compared to the Plant. The possibility of court action alone was insufficient to compel complete written contracting upon the Farm. Therefore, the Farm could afford omitting written contracts with some of

its buyers, signing many contracts *post factum* or ignoring the consequences of oral agreements in many supply transactions.

The Café was constrained neither by taxation nor accounting requirements, nor by organizational routine, network building, or planning for contingencies. Given the absence of any reasons for the reliance upon written contracts identified for the other researched companies, it became understandable why the Café Owner regularly threw her contracts with suppliers into the rubbish bin. In a similar vein, since legal recourse was out of question in the cash-operated retail trade, vendors could allow themselves to sign legally dubious contracts with retailers like the Café Owner. Yet they still undertook the hassle and annually signed these contracts as the part of organizational routine, justified by taxation requirements and network building strategies.

To conclude, an analysis of written contracts and their use by the researched companies illuminates the basic characteristics of the contractual pattern prevalent in Ukrainian businesses. It offers a temporal dimension valuable in assessing the relative importance of separate contract enforcement mechanisms discussed in the following chapters of this thesis. Short-term, relatively complete written contracting indicates a preference for the minimal formal interdependency of the trading parties operating within profound uncertainties of the transitional business environment. Taxation regulations, fiscal control and the threats of unofficial state extortions induced and routinized formal written contracts, and thereby indirectly contributed to contractual certainty in business-to-business relations. The moderate but not insignificant role of the courts at the stage of initiating the transaction later translates into the minimal but pragmatic use of commercial courts.

PART III CONTRACT ENFORCEMENT MECHANISMS

The second part of this thesis revealed a highly unstable and threatening business environment in Ukraine with a moderate level of competition and the nearly negligible customization of production. Against this environment, the findings on the high overall effectiveness of contract enforcement on the ground may seem surprising. This study has identified that only around 8% of transactions²⁵ of the researched companies were performed with some defects;²⁶ 0.3% of transactions required legal assistance through pre-trial claims (*pretenziya*) and only 0.1% ended up in court (Appendix 2). Furthermore, this study did not identify any meaningful practice of dispute avoidance at the researched companies and their trading partners, with debts at least claimed and many actually repaid. The relatively unproblematic enforcement of contracts in the last decade gave rise to greater trust between trading partners. This indicates that contract enforcement mechanisms preclude most contractual problems from arising and effectively remedy those that do. Now the question is what particular mechanisms Ukrainian businesses employ to achieve this level of contractual compliance within such an adverse business environment?

As discussed in Chapter 2, contract enforcement mechanisms could be of a diverse nature and a major split between them occurs when the state court gets involved in the resolution of contractual disputes. I follow this logic in this part and deal separately with private and public contract enforcement mechanisms. Given the various degrees of importance and complementarities, private mechanisms that ensure contractual compliance in Ukrainian business are broken into main and supporting, and discussed separately in Chapters 5 and 6.

²⁵ Transaction in this study refers to a single economic exchange identifiable through accounting documents.

²⁶ Defective performance – contract-breach – is defined in this study as any deviation of contract performance from contractual terms agreed by the parties, including one day of delay.

CHAPTER 5 PRIVATE CONTRACT ENFORCEMENT: MAIN MECHANISMS

In this chapter I explore the basic private mechanisms that ensure contractual compliance in business relations of the researched companies – repeated dealings and self-enforcing devices.²⁷

Chapter 3 of this thesis brought into light the semi-closed competitive structure of Ukrainian market as a whole and of markets of the researched companies. Therefore, the resort to repeated dealings as a contract enforcement mechanism was largely not a matter of choice for Ukrainian companies. In these circumstances, repeated dealings present the structural characteristics of business relationships rather than the contract enforcement mechanism. However, the power of the repeated dealings to induce contractual compliance was so strong and widely acknowledged by the interviewees in this study that it was impossible not to treat it as the main enforcement mechanism.

At the same time, repeated dealings of researched Ukrainian companies rarely constituted the sole enforcement mechanism, in most cases repeated dealings were tightly intertwined with self-enforcing devices in which incentives for contractual compliance lay in financial and logistical arrangements between trading partners.

5.1 Repeated Dealings

5.1.1 Importance of Repeated Trade and Reciprocity

A sequence of exchanges could in itself induce the mutual expectation of continued trading in the future, as repeated interactions may and often do lead to a reciprocal treatment of the

²⁷ In-kind exchanges or barter, which was seen in the earlier Post-Soviet transition as the preferred way to enforce contracts (Hendley *et al.* 2000, p. 640), ceased to exist meaningfully in Ukrainian business by 2010. Interviewees at the Plant told that barter was used in the 90s, but now cleaners at times found some rotten shoes at the Plant's warehouses that reminded them about barter as a bygone era in Ukrainian business.

trading partners. 'The great enforcer of morality in commerce is the continuing relationship, the belief that one will have to do business again with this customer, or this supplier' (Axelrod 1984, p. 60). Therefore repeated dealings are often referred to as the 'shadow of future dealing'.

Although repeated dealings do not equate with reciprocity because reciprocity may be experienced even in the single act of interaction (Fehr and Gächter 2000, p. 160), in the context of business to business relations both often go hand in hand. Business is 'wholly predicated upon reciprocity, this principle in effect underpins the entire enterprise' (Druzin 2010, p. 14).

The precise explanation of how the mechanism of repeated dealings operates to induce contractual compliance remains unclear. Rational-based economic and game-theoretical explanations emphasize the need for long-term finite time horizons of uncertain duration for repeated dealings to induce contractual compliance: 'although termination is certain to occur sooner or later, when this happens must be uncertain' (Telser 1980, p. 44).

Based on the experimental tradition in economics and psychology, other researchers argue that irrespective of the time-horizons, half of the population will always expect fair reciprocal treatment and will adhere to the terms of contract, even in one-off discrete interactions with strangers (Scott 2003).

Furthermore, it is not clear from the literature how often or whether at all the threat of severing the relationship should be activated to maintain the force of the contract enforcement device. Telser's theory of self-enforcing agreements, for example, assumes that:

the parties to a self-enforcing agreement do not expect any violations of it. The terms of the agreement are such that adherence is more advantageous than violation. Were they to expect violations to be more profitable than

adherence, they would not embark on the agreement in the first place (Telser 1980, p. 44)

Many empirical studies of business in developed economies confirmed that even where the contract law and common sense would prescribe that a relationship be terminated, the extra-legal strategies come to rescue it 'in all but the most acute circumstances' (Campbell and Harris 1993, p. 171).

Thus the 'shadow of the future business' mechanism operates through the threat of the termination of the relations rather than through the actual terminations. Yet the threat of termination should be actual and credible. It gains credibility, in particular when the costs in replacing an existing trading partner are high (Johnson *et al.* 2002, p. 11).

Apart from the termination of the relationship as a negative incentive, repeated dealings rely on the positive incentive of business opportunity, such as discounted prices.

Klein and Leffler in their research of quality promises enforcement found that:

a necessary and sufficient condition for performance is the existence of price sufficiently above salvageable production costs so that the nonperforming firm loses a discounted stream of rents on future sales which is greater than the wealth increase from non-performance (Klein and Leffler 1981, p. 618)

Reliance on the prospective benefits from future repeated transactions as a guarantee of the performance of existing contracts has been widely documented worldwide. For example, Mexican retail shoe stores promptly pay their vendors, otherwise shoe manufacturers refuse to resupply them and they could be forced out of business (Woodruff 1998). In contracts where potential payments may be questionable, the defaulter could lose the option of price discounts in the next transaction, provided that the relationship is continuous. Thus it is not only the prospect of future dealing, but the prospect of *profitable* future dealing that keeps the businesses together.

Additionally, expectations of future business create the possibility of conditional co-operation (Axelrod 1984), for example, by accepting an occasional delivery of somewhat lesser quality from an appreciated supplier (Rooks *et al.* 2000, p. 127). This observation is especially relevant to the business relationships in the uncertain transition to markets.

Thus in my analysis of repeated dealings in the relationships of the researched companies, I examine both the negative incentive, such as the nature and frequencies of terminations of business relationships, as well as the positive incentives, such as the practice of discounts. Based on the empirical findings, this research emphasizes the multiplicity and complexity of other contractual arrangements which accompany repeated dealings and make the threat of severing the business relationship credible. I look at the repeated dealings as fundamentally intermingled with and supported by prepayment, quality assurance, personal relations, reputation and business networks.

Repeated Dealings in the Post-Soviet Transition

The empirical research presents mixed evidence on the role of repeated dealings in the post-Soviet transition context. Repeated dealings were found to be the most widely used contract enforcement strategy in a survey of Russian and Romanian enterprises (Hendley *et al.* 2000, Hendley and Murrell 2003) and in a EBRD survey of five transition countries including Russia and Ukraine (Johnson *et al.* 2002).

However, the uncertainties of the wider business environment were thought to undermine prospects for the future interaction between trading partners (Nashchekina and Timoshenkov 2002, p. 4) who ‘had no sustained expectation of repeated interactions’ and were ‘always waiting for the proverbial shoe to drop’ (Hendley 2009a, p. 38).

Uncertainties were linked to a greater potential for frequent terminations of the business relationships. For example, Pyle's analysis of the data from the 1997 EBRD survey showed that over 60% of Polish, Slovak, and Romanian businesses reported to have a terminated business relationship with a defaulted customer in the most recent payment dispute (Pyle 2006b, p. 332). In the context of Russian transition, Jansson et. al stated that often the termination of a relationship reflects a prevailing suspicion in young as well as in mature business relationships (Jansson *et al.* 2007, p. 965). The 2007 IFC survey revealed that 40.8% of Ukrainian companies severed their relationship as an outcome of their most recent dispute.²⁸ Seemingly high level of relationship terminations prompted the analysts of the 2007 IFC survey to conclude that:

These responses would seem to indicate that many Ukrainian businesses either do not place significant value on preserving business relationships and may underestimate the cost of establishing new business partners, or can easily establish new partnerships (IFC 2007, p. 6)

In a similar way, Humphrey and Schmitz expressed doubts about the operability of repeated dealings in post-Soviet Russia where opportunism was seen as being continuously rewarded (Humphrey and Schmitz 1998, p. 43).

Thus while theory and empirical research in developed economies suggest that repeated dealings powerfully ensure contractual compliance, its operation in the post-Soviet transitional context remains unclear. The following section examines repeated dealings in the practices of the researched Ukrainian companies.

²⁸ I suggest that the high level of relationship terminations identified by the 2007 IFC survey owes much to its focus on disputes resolved in courts which indeed frequently trigger terminations.

5.1.2 Dealings with Regular Trading Partners

Definition and Number of Regular Trading Partners

The consensus among the interviewees of this study was that by the end of the first decade of the new millennium, the absolute majority of transactions were performed with regular trading partners, and these were referred to as permanent (*postoyanny*). However it was impossible to identify the coherent definition of the regular partner relevant to all three companies as it was highly dependent upon the specific industry and the size of business. Although first-time, occasional and one-off (*razovyy*) trading partners were clearly excluded from the pool of regular trading partners, the differentiation of the rest between regular and not-regular was murky.

First, the overall duration of contracting with trading partner certainly mattered for the purposes of their qualification as a regular trading partner. Generally, after the second year of continuous transactions, the trading partner came to be treated as a regular partner.

This study has identified a fairly long duration of relationships with trading partners, ranging from five to eleven years²⁹ which reflected the companies 'age' rather than any other specifics. Given that the Plant was the 'oldest' enterprise among three in this study, it had the longest business relationships of over forty years with a few large enterprises such as the Ilitskiy Plant and state-owned coalmines. Nobody knew exactly the year of their inception but they were definitely dating back to the Soviet times, perhaps to the beginning of the Plant's operation in mid 1960s.

²⁹ Author's calculation based on the data drawn from the fieldwork. Calculated as the time period from the first transaction to the end of 2011, average duration of the Plant's relationships with its buyers was 11.4 years. The Farms' and the Cafe's relationships with their buyers were 5.3 and 6.3 years correspondingly, and relationships with their suppliers were 5.2 and 6.2 years. The longest relationship identified was 40 years for the Plant, 9 years for the Farm, and 15 years for the Café.

Second, for the purpose of treatment as a regular trading partner, it was not only the duration of relationship that mattered but also the frequency of trade which varied greatly among the companies. Interviewees reported the following combinations of duration and frequencies of trade as qualifying criteria for status as a regular trading partner: three or four sales a year within two years (the Plant); a few sales a year within two years (the Farm); sales every week within one year (the Café); three or four sales even within a few months (small firm producing industrial equipment, the Plant's Supplier); sales every month within a year (trading company, the Plant's Supplier). Thus the actual duration of trading to qualify as a regular trading partner ranged from a few months to two years with certain recurrent patterns of transactions within this period of time.

Apart from the duration and frequency of working experience, two other factors influenced the status of regular trading partner – the ability to test the counterparty and the predictability of its behaviour. In order to be treated as regular 'permanent' trading partner, the history of previous transactions should be positive. According to the Farm Manager:

Permanent trading partner means a tested (*proverenny*) partner, one whom you know well. [...] The most important for permanent clients is the experience of work [Farm Manager, interview on 4 November 2009]

A positive work experience did not entail that the relationship had to be completely free of any contractual violations. Some contractual faults, namely short payment delays, were readily tolerated by the contracting parties. However, they should not cross the border into overt opportunism and unpredictability. Regular trading partners, although they may not always completely comply with the letter of contract, were expected to rescue the relationship and advance continuing trade.

To sum up, the duration of trade, combined with the frequency of trade, positive histories of interactions and the predictability of future behaviour could be considered

qualifying criteria for status as a regular trading partners in contemporary Ukrainian business.

Based on the above criteria, researched companies reported that 67% of trading partners were their regular partners (See Table 4.1). This is generally consistent with the findings of the research on post-Soviet business. For example, Malieva and Chepurensko have reported that Russian small businesses treat half of their customers as regular (Malieva and Chepurensko 2004, p. 83).

Given that the first-time trading partners of the researched companies comprised around one quarter of all partners, around 7% of the trading partners qualified neither as first-time, nor as regular and constituted the group of the partners which were in the process of gaining the status of 'regular' (See Table 4.1). This finding is in line with the main postulate of the relational contracting scholarship, discussed in literature survey of Chapter 2, that discrete and relational modes of contracting are not opposites but form a continuum – from as-if-discrete mode (between first-time trading partners) to relational (between regular partners). Therefore, trading partners of the researched companies, which were neither first-time nor regular partners, transitioned from a discrete to relational contracting mode. As the absolute majority of the trading partners were perceived by the interviewees in this study as regular, relational contracting could be seen as the prevalent mode of contracting in business of the researched companies.

Semi-Open Markets, Technological Need in Repeated Purchases and Discounts

Repeated dealings were largely not a matter of choice for the researched companies, given the semi-open structure of Ukrainian markets. Limited by a modest choice of alternative trading partners, the researched companies conducted the bulk of their trade with the regular partners, thereby retaining a permanent customer base.

From the point of view of businesses, the need for repeated dealings with the same partners was first of all conditioned by the technology of production. Understandably in the industrial sector of the Plant, the same inputs were required regularly. Likewise, the Café owner required her snacks to be supplied to her on a daily basis. Except for fuel, the Farm was the least constrained by the requirement to be supplied repeatedly with the same inputs.

Interviewees at all the three companies were quite confident about general practice in their respective industries that unless the previous debts were paid no new consignment was initiated. In a metaphoric way it was compared by one of the interviewees to a popular joke about friendship:

The turtle is swimming in the sea with the snake on its shell. The snake thinks: 'if I bite the turtle, it throws me down'. The turtle thinks: 'if I throw the snake down, it bites me' [Owner of the Small Innovation Firm, the Plant's Supplier, interview on 13 October 2011]

Technological need in regular supplies as an incentive for the enforcement of contracts came to light most powerfully at the Plant during the 'bad times' after the 2008 economic crisis. The Plant found itself in a desperate financial situation, always short of cash and therefore had to delay up to 80% of payments under credit contracts to its suppliers. Therefore, the Plant deliberately employed the strategy to increase the number of suppliers – at least two for each type of goods or services. When the Plant was in arrears to one of the two suppliers, it turned to the second one and delayed payment to it. Then the Plant repaid the debt to the first supplier and purchased from it. The Plant's supplier who terminated his relationship with the Plant owing to this policy explained that:

If the Plant wanted the next delivery it paid for the previous ones. If it did not, no payment was made irrespective of the contract. This was the scheme of work with the Plant. I was fed up by this. As I stopped supplying the Plant, they owe me till now, already for more than one year [Owner of the Small Innovation Firm, the Plant's Supplier, interview on 13 October 2011]

A similar practice by some retail traders who were 'sitting on their cash-boxes' (*sidet' na kasse*) were reported in the retail trade sector by the Café's supplier. These retailers used several vendors for the same goods to increase the time for using their trade credit.

The Farm preferred not to owe to anyone. In a hot season when the spare parts for machines were supplied often, the Farm reported the practice of settling accounts once a month and paying of the outstanding balance to the suppliers. As a rule, unless the debts for previous months were paid, new purchases were not initiated.

Thus in these circumstances the need for a next consignment from the creditor was the most powerful incentive to repay an outstanding debt.

Apart from the reliance on future purchases as a guarantee of the performance of existing contracts, repeated dealings were positively supported by the desire to increase the profits through discounts and trade credits from regular trading partners (Klein and Leffler 1981). Where the companies were most interested in attracting regular clients, they offered prepayments for goods and services to be delivered, and discounts based upon the volume of sales or related to the exclusive right of sale. The early payment of the price was rarely tied to discounts, as is practiced for example in the US (early payment discount), apparently because the payments in Ukraine were prompt anyways as compared to the standard thirty-days trade credit in the developed economies (Giannetti *et al.* 2011). Discounts were reported to be an obligatory element of the tendered contracts with the state-owned enterprises, which is discussed in Chapter 6.

Thus, apart from the semi-closed markets of the researched companies which made repeated dealings almost unavoidable, repeated dealings of the researched companies were powered by technological need in regular purchases, financial need in external funding through trade credits and the aspiration for future economic gains from discounted stream of trade.

Tolerating Defaults of Conditionally Blacklisted Partners

A specific feature of the repeated dealings at the researched companies related to the fact that some trading partners were repeatedly breaching their contractual obligations yet still were treated as regular, albeit ‘conditionally blacklisted’ trading partners. These trading partners were avoided where it was possible, but where profit considerations required it, the companies still dealt with them.

While deficiencies in quality of traded goods and services as a rule were not tolerated, conditionally blacklisted trading partners frequently delayed payment or delivery. The interviewees at the Plant put it straightforwardly: ‘delays are the norm for these enterprises’ [Sales Manager C, the Plant, interview on 5 November 2010]. However, the researched companies were aware of this possibility and were able to predict an actual payment date or to negotiate it with some degree of certainty. According to the Farm Owner:

We always know how they will pay but we put it in the contract differently. For example, Beta says honestly 'I can pay only in a month', so we put one month in a contract. But, for example, Kaskad always writes one week in their contracts. We tell them 'One week? You will pay in a month at best!' But they do insist on one week and we leave it this way [Farm Owner, interview on 25 December 2010]

Conditionally blacklisted trading partners were divided into 'bad payers' who were constrained by the constant lack of cash in their business, and 'bureaucrats' where delays were caused by organizational inefficiencies.

'Bad payers' were those enterprises which locked themselves into a vicious circle of payment delays that ultimately and inevitably caused decrease in their profits. Payment delays were firmly tied to the price, and the 'bad payers' companies continuously ended up with the prices lower than average on the market. As a result of these circles, they could not simply afford to pay on time, as all their operations fed on the cash saved from the due payments.

Despite the security screening policy discussed in the following chapter, a few 'bad payers' managed to get onto the list of regular customers of the Plant. A distinct group of known 'bad payers' comprised the state coalmines that were permanently underfinanced by the state. Apparently the profitability of transactions with them outweighed the headache of regular delays.

Kaskad was a notorious example of a well-known 'bad payer' in the agricultural market of Donetsk (Case 2.3 Kaskad, Appendix 3). However, when the corn was found to be decaying and needed to be urgently sold, Kaskad was the only saviour and its payment delays were forgiven by the Farm. Eventually, the Farm manager concluded that they had good 'human' relations with Kaskad.

Finally, the Café Owner reported a competitor who was well-known among vendors to delay her payments on purpose to raise money for an ongoing construction project.

Another group of conditionally blacklisted trading partners comprised some large companies, mostly privatized ex-Soviet industrial enterprises, whose organizational efficiency left much to be desired and created a few problems.

The typical example of such inefficiency was offered by the Sales Managers of the Plant and was referred to as ‘the system of budgeting’ (*sistema byudzhetrovaniya*). These systems comprise the computerized procedure of fund allocation among departments and outside creditors that entails multiple internal coordination and centralized decision-making. At some large companies this involves a burdensome procedure of written communications between a purchasing manager and his supervisors, and ultimately requires the approval of the shareholders. For such companies, a delay of five days for payment was accepted practice and did not lead to active debt collection.

The similar complaint about ‘bureaucracy’ was reported by the Farm with regards to its supplier of agricultural machines Newholland. The relationship was hampered by the distant location of the supplier in the neighbouring Dnepropetrovsk region. The Farm Manager often complained that because of the lack of coordination between departments, decisions were taken too slowly and the Farm was deprived of good quality after-sales service (Case No 2.6 Newholland Combine, Appendix 3).

On top of these frustrating problems, conditionally blacklisted trading partners sometimes ‘had a difficult communication style’ which ‘spoiled the mood’; treated others ‘as a smart aleck (*po-khamski*)’; ‘had small volumes of purchases, too low or too high prices, difficulties in keeping up correspondence’; or behaved themselves as *shalopay*. According to the Sales Manager:

'*Shalopay*' is a client who can deceive, say 'yes, I have already sent you the money' but in fact will only send it tomorrow, and make up excuses. But in any case I know them and I am ready for such behaviour [Sales Manager B, the Plant, interview on 13 December 2010]

Thus, given the moderate level of competitiveness at the markets of the researched companies, conditionally blacklisted trading partners were treated by the researched companies as regular despite the fact that they often broke their contractual obligations. Given this finding, the pool of regular trading partners of the researched companies indeed was substantial.

Few Terminations of Business Relationships

Relationships of the researched companies with their trading partners could be terminated for a range of different reasons. The partner company may cease to exist, may get reorganized, vertically integrated or go bankrupt without breaking any contractual promises at least to some of its customers. The partner companies in some cases may depart simply because of the personality clash of the employees which has no connection to the quality of the contractual performance whatsoever. A change of technology, entrepreneurial strategies or the macroeconomic situation can reduce the demand for the goods traded between the parties, and the supplier-buyer relationship can die naturally. The most common reason for the termination of relationships is connected with the unacceptable price policy of the trading partner whose prices became higher than those available elsewhere on the market. Finally, the trading partner may break the contract or may be suspected to break its promises in future, and this could lead to termination of the relationship. Repeated dealings as a contract enforcement mechanism relies only at terminations of business relationships caused by defective contract performance but not caused by the other reasons.

This study documented that even where terminations of the relationships were clearly triggered by an unsatisfactory contractual experience, the decisions to cease the relationship were not often communicated to the trading partners. As discussed earlier in Chapter 4, Ukrainian companies consciously tightened the time spans of their transactions and avoided formal interdependency in contracts or other documents. Consequently, an informal business relationship did not require formal evidence of termination. Therefore the defaulting party was not likely to realize that it had been refused an immediate business opportunity until it became obvious.

This point is illustrated by the example of the termination of the Farm's relationship with the Makeyevka Mill (Case No 2.4, Appendix 3). Notwithstanding the default on the previous contract and two-year-old debt, the Mill's manager called the Farm Owner enquiring about a possible sale. Instead of explaining that the Farm would not trade any more with the Mill, the Owner politely responded: 'No, we do not have any grain left to sell you.'

The implicit nature of terminations of business relationships was explained by the possibility of their renewal. It was reported by the interviewees in this study that the terminated relationships were not crossed out of the customers' lists but rather put 'on reserve'. It was possible that the relationship once terminated was renewed again. In certain cases, distrusted and blacklisted trading partners would be contracted under the so-called protected schemes:

Yes, I will work again with Makeyevka Mill [relationship terminated in 2009] in case their financial position improves again and the deal will be very profitable. But I won't trust them. I will demand a super offer – very high prices, I will make them pay 100% prepayment and repay the old debt. So, such a dealing would be unilaterally profitable to me [Farm Owner, interview on 26 December 2011]

If termination happens I always try to bring the client back. I keep calling them, ask about their plans, make sure that they do not forget me. We do not abandon clients [Sales Manager B, the Plant, interview on 12 December 2010]

Even the court decision in a lawsuit did not always put an end to the relationship, and the parties continued to transact albeit through prepayment arrangements. Relationships in seven of nineteen court cases of the three researched companies were renewed immediately or after a few years. For example, although the Plant sued Dneprovskiy for unreturned cable drums in 2006 the new contract was signed in 2011 (Case No 1.2 Dneprovskiy Plant, Appendix 3).

Finally, taking into account the implied and conditional nature of the terminations of business relationships of the researched companies with their trading partners, it comes as no surprise that the interviewees did not regard the threat to terminate the business relationship as credible:

Yes, we use the threat to terminate the relations even more than our partners use it towards us. We can say it to anyone – from minor partner to a large one. But it is a weak threat, it works weakly [Farm Owner, interview on 26 December 2011]

Thus the potency of the threat to terminate the business relationship was undermined by the possibility of renewal of cooperation between the trading partners. Owing to the implied and conditional nature of terminations of business relationships caused by defective contractual performance, their identifications required thorough research through enquiries into the reasons for terminations.

Through the qualitative methodology of this research, I was able to record only two dozen relationships which were terminated in 2004-2011 as a result of contractual faults by the trading partners or the researched companies, with or without court interventions (See Table 5.1).

Table 5.1 Relationship Terminations Caused by Defective Contractual Performance³⁰

Years	PLANT		FARM		CAFÉ		Total
	<i>Suppliers</i>	<i>Buyers</i>	<i>Suppliers</i>	<i>Buyers</i>	<i>Suppliers</i>	<i>Landlords</i>	
before 2008	2	NA	3	0	0	0	5
2008	5	0	1	1	0	0	7
2009	3	2	0	1	0	1	7
2010	2	1	0	0	0	0	3
2011	1	1	0	0	0	0	2
Total	13	4	4	2	0	1	24

As illustrated by the table above, within the last five years the Café has terminated one business relationship with her landowner in 2009, and not a single relationship with her suppliers. The emotional and dismissive reaction of the Café Owner to my question about terminations is illustrative:

We never ever had any terminations of relations caused by the suppliers' bad work. Are they crazy? The 'human factor' such as a drunken porter or a driver did happen but these were small things and never caused terminations of relationships [Café Owner, interview on 7 September 2011]

The interviewees at the Farm could also recall only six terminations during the time of the Farm's operation since 2002. Nor could a closer analysis of the accounting records for 2008-2010 reveal higher rate of terminations. During this period, three suppliers were

³⁰ Source: Data drawn from author's fieldwork.

blacklisted by the Farm because of the defective quality of goods and services (Case No 2.8 Valdi, Case No 2.1 Don Combine, Case No 2.6 Newholland Combine, Appendix 3). One termination of supplier relationship was caused by the Farm's own negligence in payments (Case No 2.5 Mariupol Farm, Appendix 3). Two buyers – Makeyevka Mill and Volnovakha Poultry (Cases No 2.4 and 2.9, Appendix 3) – were blacklisted as a result of their actual or potential non-payments and subsequent bankruptcies.

The dynamics of the Plant's terminations of the business relationships before 2009 were generally similar to the Café's and the Farm's terminations. This study documents only four terminations of relationships with the Plant's buyers (for example see the Case No 1.3 DUEK, Appendix 3) and thirteen terminations with suppliers (Case No 1.5 Congo Rubber, Appendix 3). The former were mostly caused by payment problems of the Plant's buyers, and the latter by quality deficiencies of the supplies. It was confirmed by the sales managers that the Plant 'never abandoned' its clients:

Clients do not leave us. They may not need our cable for some time, they may get restructured and abandon activity that requires our cable. But they do not leave us because they are unhappy with us. In order that the client blacklists us, we have to do really bad things [Sales Manager C, the Plant, interview on 5 November 2010]

The clients are never crossed off our customer lists. Today the client may have it this way, tomorrow – that way. Then the situation may change and they will have money again. We do not abandon clients [Sales Manager B, the Plant, interview on 13 December 2010]

After the 2008 global crisis when the Plant found itself in financial distress, there were grounds to believe that the numbers of terminations caused by the Plant's payment and delivery delays increased.³¹ Yet the sales managers and the lawyers were quite certain

³¹ Precise information on the number of terminations was not revealed to me because it was perceived negatively influencing the Plant's image. It was reported by the former employee of the Plant, who had left his job after the 2008 crisis, that 40% of buyers have terminated their contracts with the Plant in 2009-2010. Nevertheless most of these terminations were caused by the dissatisfaction with the prices, but not by the defective contract performance of the Plant.

that trading partners did not abandon the Plant massively after the crisis. For example, the Head of the Legal Department confirmed that suppliers were patient with the Plant's payment delays:

Yes, it is the fact that the Plant often delays payments to its suppliers now, after the crisis, but the suppliers generally do not leave. The Plant is at least the large enterprise and it pays by bits albeit slowly [Head of the Legal Department, the Plant, interview on 9 November 2009]

Thus, even by 2011 when the Plant was already teetering on the edge of bankruptcy, most trading partners did not rush to terminate their business relationships with it.

To conclude, actual terminations of business relationships caused by the faulty contract performance of the parties turned out to be a rare phenomenon in the business of the researched companies. Given that the researched companies annually trade with around 400-500 buyers and suppliers, the two dozen terminations identified over the period 2004-2011 was not a substantial amount. Although after the 2008 crisis the number of terminations of the Plant's business relationships could have increased beyond the level revealed in this study, it was not believed to be substantial. Where terminations occurred, they were often implicit and did not exclude the possibility of the renewal of the relationship in future, even after a court action. Thus repeated dealings were not supported by a credible threat to terminate relations but by the threat of the denial of a short-term business opportunity within an informally preserved relationship.

Preference for Repeated Dealings Even in Discrete Contracting

The interviewees expressed a high normative preference towards trading with the regular customers. All the interviewees perceived their business as building upon regular, stable and ongoing business links with the same well-known trading partners, although it was

only the Plant which actively invested to secure regular trading partners – to ‘earn’ them (*narabotat’ postoyannykh kliyentov*). Such a policy was reported to be the general trend in the cable manufacturing industry. For example, in 2006 the Plant’s Vice-Director for Supplies talked to most of the suppliers to ‘persuade them that the Plant is their strategic trading partner; that it works for a long at the market and pays in time’ [Vice-Director for Supplies, the Plant, interview on 28 October 2008].

The Farm and the Café also valued their regular trading partners highly. Although they did not employ any special tactics to attract regular clientele, these were their suppliers who were interested in upholding regular trading relations with them. Owing to the suppliers’ efforts the Farm and the Café also ended up working within semi-closed business networks.

Thus in one way or another, all three companies eventually found themselves tied to regular trading partners and perceived their business networks as those where ‘everyone knows everyone’.

The ‘shadow’ of repeated dealings was projected even across discrete transactions. Many first-time trading partners hoped for the initiation of continuous cooperation with each other in the future. Even where this was not feasible, for example, in one-off construction and installation projects, opportunistic temptations were restrained by the consideration: ‘What if I will have to deal with this trading partner sometimes again?’

Furthermore, first-time dealings were frequently and consciously broken into smaller transactions akin to repeated dealings. This simple bilateral arrangement is apparently relied upon in various parts of the world. For example, Dietz, who researched software industry in Germany, India and Eastern Europe, has demonstrated how businesses structured their relationships ‘in milestone phases’ and thereby turned the transaction from

a simple one-off interaction into repeated game (Dietz 2012). This arrangement provided incentives to both buyers and the sellers. The buyer received an opportunity ‘to test by bits’ the quality of supplied goods, and the seller to get more insight into the organizational and payment routine of the buyer.

Given the straightforward nature of most transactions at the researched companies, Ukrainian businesses did not break the contract into ‘milestone’ phases with well-defined assignments and a final outcome, but rather into a series of identical transactions with small amounts of traded goods in each transaction. This arrangement was referred to by the interviewees in this study as ‘trading with small amounts’ and was relied upon by the researched companies and their trading partners of all sizes. For example the Plant’s supplier reported:

Initially there is zero trust of new partners. I tell my buyers – do not take much from the very beginning, take a few and if you like it come back. Such an attitude attracts people [Owner of the Small Innovation Firm, the Plant’s Supplier, interview on 13 October 2011]

A similar strategy of the Farm was evident in respect to first-time buyers. For example, although it was apparently possible to sell grain to the Farm’s first-time buyer Veresk as one batch, it had four transactions and signed four contracts with the Farm on April 9th, 13th, 15th and May 5th 2009. The Café Owner also always took samples of the new products before committing to buying larger amounts.

Thus the ‘shadow’ of repeated dealings generally covered all the transactions of the researched companies including a discrete type of contracting with first-time trading partners. Moreover, repeated dealings as a contract enforcement strategy was consciously chosen by the researched companies for the purpose of the initiation of certain business relationships through ‘trading with small amounts’.

To sum up, this study confirms the overwhelming reliance of the researched companies on repeated interactions, continuing business relationships of considerable duration, and a unanimous normative preference for repeated trade. Compared to developed economies, repeated dealings in Ukrainian business appeared to exhibit a few notable specifics. On the one hand, conditioned by the semi-competitive market structure and a low level of technology, repeated dealings lasted for years, trading partners were willing to resort to this strategy even in discrete type of contracting, terminations of business relationships were extremely rare and revocable, and many defaults of the trading partners were tolerable. On the other hand, businesses avoided the formal and informal interdependency of the trading partners, and relied upon the denial of an immediate business opportunity within informally preserved business relations.

5.2 Self-Enforcing Mechanisms

Researchers of the contracts in developed economies attempted to pin down the informal self-enforcing mechanisms which ensure that the transaction is performed as agreed, without any interference of third-parties, or does not happen at all. In other words, in a self-enforcing agreement if 'one party violates the terms the only recourse of the other is to terminate the agreement' (Telser 1980, p. 27). According to Scott, 'if the parties themselves can create efficient extra legal mechanisms for coping with problems of hidden action and hidden information, then they will be indifferent to legal enforcement' (Scott 2003, p. 1645).

Although some studies treated repeated dealings and reputation as self-enforcing devices, they could be considered as such only under certain conditions. Repeated dealings generally guarantee contractual compliance except in the end-game scenario where the

anticipation of the last transaction may cause the cooperative relationship to unravel (Scott 1987, p. 2033). In a similar manner, reputation guarantees self-enforcing agreements only if business networks are able to disseminate credible information about the defaulter among the network members and collectively punish them (Greif and Kandel 1993, p. 11, Scott 2003, p. 1646). In contrast, mechanisms that provide for the unconditional enforcement of contractual promises render defective performance largely impossible. For example, the prepayment requirement unconditionally enforces the payment obligation of the buyer because unless the buyer pays for the goods, the goods are not delivered and economic exchange does not happen. Thus this section is devoted to those mechanisms that unconditionally self-enforce contractual promises.

Compared to contract enforcement through repeated dealings, self-enforcing mechanisms in most cases differ for buyers and sellers. For example, the self-enforcing device of prepayment only protects one side – the seller – from unreliable behaviour by others. In a similar vein, the payment arrangement of the ‘flea market’ type of transactions – cash upon delivery – ensures the complete fulfilment of payment obligations while a deficient quality may become apparent only later. According to Maze and Menard, complex problems of quality measurement and verification requiring specialized expertise entail limitations to the contract enforcement ability of courts and impose serious risks on buyers (Maze and Menard 2010, p. 143). Thus buyers require protection from quality defects and delivery delays by sellers.

In the post-Soviet context, prepayment has been widely studied, whereas the buyer’s mechanisms to enforce quality and delivery promises has attracted far less scholarly attention. It happened, perhaps, because the quality and delivery problems did not manifest themselves as alarmingly as inter-enterprise arrears due to the high level of

production standardization. This research demonstrates that self-enforcing devices are different for buyers and sellers, and therefore are separated in the following sections.

Delivery delays did not constitute meaningful problems at the researched companies, as standardized production minimized their probability. It was possible for most industrial enterprises to maintain a strategic stock of inputs at their warehouses. Furthermore, for suppliers it was easier to achieve a timely delivery than the perfect quality of their supplies. Finally, given the asymmetrically higher level of competition among suppliers, delivery delays rarely constituted contractual problems between trading partners in this study. Therefore, this study has not identified self-enforcing contractual devices that were directed specifically to ensure the timely delivery of supplies.

Thus the following subsections discuss in greater detail the self-enforcing mechanism designed to protect the seller – prepayment – and the self-enforcing mechanisms protecting the buyer from quality problems – trade credits and quality assurance.

5.2.1 Protecting the Seller: Prepayment

The payment obligations of the Café towards its suppliers were guaranteed by on-the-spot cash payments upon the delivery of goods at the kiosk's and café's premises. The spot market nature of these transactions did not give rise to a meaningful risk of opportunism. In contrast, the Farm and the Plant were operating through their bank accounts and their transactions were spread over time. To ensure timely payments for goods sold, both companies extensively resorted to the mechanism of prepayment.

Prepayment refers to contractual arrangement between two parties when no goods are dispatched or services are rendered unless the seller's bank confirms the payment. It

may be full or partial – when the certain percentage is paid in advance and the rest works as a trade credit.

Prepayment could be regarded as ‘one solution to the fundamental informational asymmetry, in which the customer’s ability to pay is much difficult to ascertain than the supplier’s ability to pay’ (Hendley *et al.* 2000, p. 639). Yet this self-enforcing mechanism is not used often in developed market economies where buyer-supplier contracts generally rely on a thirty-day trade credit arrangement (Johnson *et al.* 2002, Giannetti *et al.* 2011). While prepayments were found unusual in stable market economies even for one-off transactions of a discrete type (Johnson *et al.* 2002, p. 234), the use of prepayment in the post-Soviet transition acquired a truly universal character, discussed below.

Prepayment in Transition Markets

Prepayment was seen as a primary and sometimes as the sole deterrent of opportunism in the post-Soviet transition. Over two-thirds of the Bulgarian firms in Koford and Miller’s survey required either pre-payment or on-the-spot payment for goods in the early transition years (Koford and Miller 2006). Hendley and others documented exceptionally high level of demands for, and actual, prepayments in Russia:

75% of enterprises included a clause in their sales contract requiring some sort of pre-payment; 41% of enterprises demanded full (100%) pre-payment. The average pre-payment commitment of customers was 54% and the amount actually paid was 48%. Some 74% of contracts for material supplies required some pre-payment, with 45% of such contracts requiring full pre-payment (Hendley *et al.* 2000, p. 639)

In empirical research of the contractual patterns of Russian businesses, Hendley found that most of the problems with contractual performance in Russia arose ‘when members of the sales department let down their guard and extended trade credit to a once-favoured customer’ (Hendley 2009a, p. 23).

Furthermore, it is a general rule documented by empirical studies in Russian and Ukrainian business that first-time contracting partners are required to prepay their contracts in full (Radaev 2004). By gradually decreasing the amount of prepayment and eventually extending it to the trade credit, ‘the firm might be able to sort fly-by-night firms from those with longer time horizons’ (Johnson *et al.* 2002, p. 12). It is not surprising that the further away geographically the buyer is located, the more likely it is to make an advance payment (McMillan and Woodruff 1999, p. 647).

The prevalence of prepayment in transitional business was treated by the researchers as suggesting ‘an environment with very difficult conditions for combating fraud’ (Koford and Miller 2006, p. 18). It is commonly understood that in the transition context, prepayment signals distrust of the trading partner. Hendley and colleagues found that trust was ‘inversely correlated with the amount of prepayment’, as the first-time contracting partners paid 60% of the price in advance compared to 44% of the price paid by others (Hendley *et al.* 2000, p. 639). The fact that Russia scores very high in terms of prepayment requirements and scores lower than average in terms of trade credit was used by Radaev to illustrate the low level of trust (Radaev 2004).

Thus prepayment has been unanimously reported by all the researchers to be very popular, if not the most exploited, contract enforcement method in the post-Soviet context. Yet the precise nature and functions of this device are less explored. Although some of the functions – for example the need to finance production – were acknowledged by the researchers (Hendley *et al.* 2000), they were not dwelled upon. This study seeks to expand the understanding of the enforcement and extra-enforcement functions of prepayment that are specific to the transition context.

Prepayment at the Researched Companies

In line with the research discussed above, this study confirms the substantial use of prepayment by the researched Ukrainian companies. According to Table 5.2, prepayment clauses were included in 63% of the Plant's and 53% of the Farm's contracts. Most prepayment terms required advance payment of the full price, while a minority were partial prepayments and the so-called 'payment on the date of delivery' or 'the same day payment'. The latter referred to arrangement when the procedures of payment and loading of goods started simultaneously and took from two to five hours, yet the goods did not leave the premises of the seller until the bank confirmed the payment received.

Table 5.2 Distribution of Payment Terms in Contracts in 2009 (%)³²

Payment terms	Plant	Farm	Café
100% prepayment	51	46	0
Partial prepayment	8	0	0
Payment on the date of delivery	4	7	0
Trade credit	35	36	73
Payment terms missing or impossible to identify	2	11	27

Figures presented in the table above are substantially higher than those identified by McMillan et al. in Vietnam (35%) (McMillan and Woodruff 1999); by Bigsten et al. in African countries (4.3%) (Bigsten *et al.* 2000); by Beale and Dugdale (1975) in the UK (not identified at all); but are lower than the figures documented by Hendley et al. in Russia in the end of the 1990s (75%) (Hendley *et al.* 2000, p. 639).

An important finding of this study is that prepayment in contracts of the researched Ukrainian companies was motivated by reasons beyond the attenuation of opportunism of the trading partner, and exhibited different functions in relationships with new and regular trading partners.

Prepayment in Discrete Contracting with the First-Time Trading Partners

As already noted, given the disproportionately high competition of vendors for retailers on the Ukrainian retail market and cash-based trade, the use of prepayment was excluded in Café's business. The Café Owner made all the payments for delivered goods on spot in cash upon delivery.

³² Source: Data drawn from author's fieldwork.

The interviewees at the Plant and the Farm confirmed the generally accepted rule which perhaps could already be treated as a trade custom in their industries – that first-time buyers are required to pay 100% of the price in advance. The same rule applied in turn for the Plant and the Farm when they purchased their supplies for the first time. Indeed, all the new buyers at the Sales Department of the Plant prepaid their sales in 2009. Similarly, all the Farm's 2009 new buyers paid 100% prepayment, and only one had three days trade credit in the contract, but in fact prepaid three out of six transactions.

Furthermore, all interviewees reported that they were perfectly able to distinguish the fly-by-night firms or 'one-day firms' (*firmy odnodnevki*) – the companies established for short-time with the aim to default on tax payments to the state.³³ These firms always have to prepay their contracts fully.

The first-time prepayment requirements had a tendency to be gradually decreased for subsequent transactions with the same trading partner. Although the Plant always asked for prepayment to finance its inputs, when the buyer insisted the Plant decreased the amount prepaid at some point after six months of contracting. The Farm's practice was to ease prepayment requirements after the fifth sale.

At the same time, there are always exceptions to the rule. The Plant and the Farm reported that their large, most important buyers – Ukrainian as well as multinational corporations – have an express policy of contracting only on the conditions of trade credit. These corporations with well-recognized brand names could make an honour to any supplier (the reputational mechanism of brand names is discussed in more detail in Chapter 6). Therefore, in order to attract such a buyer the supplier would not even mention prepayment during contract negotiation.

³³ The Plant's Economic Security Department kindly offered me the list of 139 hints that they use to distinguish fly-by-night firms.

Even less famous and smaller companies could avoid first-time prepayment requirements provided the first-time transaction is broken into a series of smaller ones, thus transforming the very first interaction into repeated dealings, which was discussed in the previous section.

Thus, although this study documents the high reliance on prepayment in the business relationships of the researched companies, the first-time prepayment requirement could be overcome in certain cases through mechanisms of reputation and branding and through trading with small amounts.

Prepayment in Relational Contracting with Regular Trading Partners

Given that the level of prepayments, identified in this study, was 63% for the Plant and 53% for the Farm (See Table 5.2), while the number of the first-time partners was around one third (See Table 4.1), it becomes obvious that regular trading partners were also affected by prepayment. Interviewees confirmed their resort to prepayment clauses in long-standing relationships.

As it was demonstrated by the previous section of this thesis, the mechanism of repeated dealings in the relationships with long-time regular trading partners sufficiently guarantees contractual compliance in Ukrainian business, for these relationships prepayment would seem to be unnecessary. Yet they were still used and were motivated by factors other than enforcement considerations. The rest of this section seeks to illuminate these non-enforcement uses of prepayment.

First, in the context of the long-term relationship, prepayment became an element of the pricing mechanism – the higher the prepayment the lower the price, and the longer and the higher the trade credit the higher the price. Prepayment in this perspective may be

treated as a part of bargaining and price mechanism. The interviewees in this study reported that a willingness to pay upfront could decrease the price of goods from 5 to 25%.

Second, in certain cases prepayment reflected the express entrepreneurial strategy of the company. The companies that pursued a policy of never paying in advance – mostly large well-off industrial enterprises – were well known on the markets of the researched companies. Furthermore, in relatively stable economic conditions of the Ukrainian market in 2005-2008, the smaller companies substantially improved the stability of their cash flows and consequently felt free to pay upfront for supplies. For example, it was reported by the Farm Manager that the Farm often prepaid its supplies as a bargaining strategy.

Third, prepayment was a universal means of working credit especially valuable in the post-Soviet transition. When the bank loans are not easily accessible and ‘businesses operate in a fragile balance between the liquid resources that come in and go out’ (Vinogradova 2005, p. 151), the mutual financing of businesses through prepayments and trade credits becomes almost the only viable scheme. Hendley viewed the lack of available credit, which disabled some enterprises to finance the costs of production, as a ‘particular problem for those enterprises with a long production cycle or those that manufactured big-ticket custom-made equipment’ (Hendley *et al.* 2000, p. 640).

Among the three researched companies, the Plant was very sensitive to credit resources because of the costs of its inputs, especially after the 2008 economic crisis. Therefore, some well-off Ukrainian companies, such as the metal plant Azovstal or the state-owned Ukrainian railway which requested trade credits of respectively 30 and 120 days, were automatically excluded from the pool of the Plant’s potential customers.

The standard form contract of the Plant was based upon the complete prepayment of transactions from buyers and allowed 40 days for cable delivery after payment. Most of the

Farm's prepayment clauses contained ten-day delivery terms after prepayment was initiated. Although in reality prepaid deliveries were much quicker than forty days at the Plant, and ten days at the Farm, the function of the prepayment as a working credit was acknowledged by the interviewees by one phrase: 'we ask for prepayment when we need money'.

Fourth, prepayment requirements may not only be decreased with time but increased as well; in this case it serves as a punishment for defaulting regular customers. These types of sanctions are recognized by the Commercial Code of Ukraine (Articles 235-237) and referred to as 'operative-commercial sanctions' (*operativno-khozyaystvennyye sanktsii*), meaning that they are fully within the discretion of the private parties and do not require any involvement of the courts. Prepayment as a sanction was applied by the Plant in its relationships with coalmines, which delayed payments and yet needed to purchase from the Plant due to their technological or other requirements. It was also reported that prepayment as a sanction was frequently introduced when litigation in commercial courts did not terminate the business relationship. The customers who were forced to switch from trade credit to prepayment contractual terms were often simultaneously 'conditionally blacklisted', yet remained to be treated as the regular customers.

Finally, in contrast to conventional wisdom, prepayment may serve as a signal of trust and loyalty. According to the Farm Owner:

Prepayment does not always mean distrust. Sometimes it reflects very good relations. For example, when one partner needs money urgently, he gets prepayment from its permanent customer [Farm Owner, interview on 4 September 2007]

The analysis of the Farm's relations with its long-standing and trusted trading partners revealed a high level of prepayment, both from the regular customers and to the regular suppliers. The pattern was the following: the first few transactions in the calendar

year the Farm and its regular customers prepaid and the rest of transactions were paid after the delivery. In these cases, prepayment from and to regular trading partners was in no way the sign of distrust. In contrast, it served as a signal of trust, as a kind of investment in trustful relations that everyone was expected to make, as a sign of good will and appreciation of the relationship. According to the interviewees, exceptionally long and high prepayments could also indicate a special trusted relationship with the friend or relative.

To sum up the overview of the functions of prepayment identified at the researched companies, this research confirms its use as a shield against the opportunism of counterparties, primarily in relations with first-time trading partners. At the same time, this study reveals that prepayment simultaneously served as a means of providing working capital, as an element of pricing mechanism, and as a punishment in relationships between regular trading partners. While the use of prepayment in respect to unfamiliar trading partner definitely signifies distrust, prepayment may also indicate trustful relations with long-standing customers or a certain entrepreneurial strategy of the company. Finally, even in relationships between regular trading partners, prepayment retained its contract enforcement role although this became secondary and supplementary to the functions identified above. Thus prepayment carries out so many functions in the post-Soviet transitional context that it should not be considered as an indication of distrust in business relations.

5.2.2 Protecting the Buyer: Trade Credit and Quality Assurance

While prepayment protects the seller from payment defaults, the buyer in this scheme remains exposed to possible problems with the quality of goods and their delivery. Product quality is generally considered to be taken care of sufficiently by the mechanisms of repeated dealings, reputation and brand naming.

For example, Klein and Leffler found that this is indeed the case provided that the price of the product is greater than market price. Their model shows the ability of markets to guarantee quality even in the 'absence of any government enforcement mechanism' (Klein and Leffler 1981, p. 617). In a similar line of thinking, Sako has empirically demonstrated that a better quality and prompt delivery of supplies is enabled by relational type of contracting, rather than arm's-length [discrete] contracting between trading partners (Sako 1992, p. 239).

In practice, apart from the repeated dealings mechanism, many other devices of self-enforcing character ensure product quality, for example technical standards, certification procedures and quality verification by buyers or designated organizations.

Technical standards accepted in dealings between the parties, in a certain industry or on a nationwide level could be enforced bilaterally between the parties, or through the quality verification collective organizations. Lane (Lane 1997) and Arrighetti et al. (Arrighetti *et al.* 1997) in their empirical research of inter-firm cooperation found that the promulgation of technical standards by the German state and state-sponsored private bodies such as the *Deutsches Institut für Normung* contributed to a strong regulatory environment in Germany and consequently produced certainty in the contractual relations of industrial firms. In Britain, the role of collective institutions was weaker and technical standards played a generally less central role, which was found to decrease the quality of contract

enforcement. A similar contract enforcement enhancing effect of collective institutions, which monitored the quality of products, was reported by the study of French agriculture by Maze and Menard (Maze and Menard 2010). They concluded that it was crucial for certifying organizations to be backed up by public order through a set of rules that govern the parties.

In post-Soviet Ukraine, businesses were far less concerned with quality than payment problems, because standardized production required only minimal quality standards and issues of improved quality and innovative technologies had not yet gained prominence. Quality problems did not arise frequently at the researched companies. Where deficiencies of delivered inputs were detected, the sellers were reported to be always willing to remedy the defects promptly.

For example, the Head of the Technical Quality Department of the Plant reported to have remembered not a single case within the last seven years when the suppliers or the Plant refused to repair or replace any deficient goods. The Plant always replaces its cable, even when the defect has been caused by the fault of the buyer. While this fact was proudly reported by the Plant's Director as Plant policy, the sales managers offered more pragmatic explanation:

It is in any case profitable to the Plant to take back the disputed cable. If it is fine we may resell it. If it is bad – it is bad and we must take it back anyway [Sales Manager C, the Plant, interview on 3 September 2007]

Within the last eight years, the Farm had only two cases of defective supplies when the sellers refused to remedy the defects. In the Don Combine Case (Case No 2.1, Appendix 3), the Farm had to sue the reluctant seller and the latter went into bankruptcy leaving the court judgment unenforced. In the second case, the Newholland Combine (Case No 2.6 Appendix 3), the defects and the fault of the seller have not been proven and the

dispute did not escalate into a court case. In all other quality issues, the Farm itself and the buyers promptly remedied the defects.

In the only case of quality defects reported by the Café (Case No 3.2 Coca Cola Outdate Goods, Appendix 3), the supplier immediately replaced the out-of-date goods which caused no serious damage to the Café Owner.

Thus, given the very low level of product customization, suppliers were able to easily substitute standardized inputs, and problems with the quality of supplies largely did not arise in the relationships of the researched companies. In circumstances where more suppliers compete for a smaller number of buyers, the contract enforcement mechanisms discussed in the following sections gained a nearly unconditional self-enforcing capacity.

Trade Credit and Unilateral Price Adjustments

In contrast to prepayment, trade credit (or extended payment – *otsrochka platezha*), is rarely seen as a contract enforcement device. Trade credit is primarily considered a valuable source of external financing of firms, especially in a transitional business where bank loans are restrictively accessible. For example, Johnson et al survey identified that trade credit contributed to 45% of external financing of Ukrainian firms (Johnson *et al.* 2002).

Apart from being a valuable source of external financing, trade credit was studied by the researchers of developed and developing markets alike as an ‘integral part of the firm’s pricing policy’; as a ‘selling expense like advertising’; and as investment into customer relations (Summers and Wilson 2003, p. 440). Finally, trade credit was acknowledged to bear contract enforcement capacities as it ‘allows the buyer time to examine the goods and ascertain product quality or to ensure that a service has been correctly performed’ (Summers and Wilson 2003, p. 441).

Credit transactions ensure the proper performance of quality promises through the possibility of the unilateral adjustment of the price. In credit transactions, unless the buyer is satisfied with the quality and delivery, it does not pay the contract price. Should any deficiencies be detected after the delivery, the buyer has an automatic option to unilaterally adjust the price of the goods to be paid.

This study reveals that trade credit constituted primary payment terms in 35% of the Plant's contracts, 36% of the Farm's contracts and 73% of the Café's contracts that I managed to review (See Table 5.2). Although the average duration of trade credits was seventeen days, most did not exceed ten days.

Although trade credit terms were included in the minority of transactions of the researched companies, the interviewees in this study acknowledged the capability of trade credit to protect the buyer from quality deficiencies. Yet actual unilateral price adjustments due to defects in the quality of supplies were identified only in a few cases.

The Farm had to bear the consequences of a few price adjustments by its buyers when the quality of the Farm's grain was objectively lower than agreed in the contract. The Plant decreased the price for inputs with minor defects and still put them to production a few times. Yet at least in one case the risks were too high and the cable produced with unsatisfactory inputs was substandard (Case No 1.5 Congo Rubber, Appendix 3).

Thus trade credit was acknowledged to function as a contract enforcement device, but very rarely due to the infrequent quality problems at the researched companies.

Certification

During the course of the empirical fieldwork in 2008-2011, Ukraine operated a system of national certification inherited from the Soviet Union. It required producers to certify most

types of goods with the centralized certification body and entailed annual audits of producers' facilities and the examination of goods by the state agencies. In contrast to best practice in developed economies where certification is voluntary and mostly private, the Ukrainian certification system was state-run, mandatory and highly centralized.

The state certification system in contractual relations implied that pursuant to mandatory state certification, every batch of goods delivered in each transaction must be accompanied by a certificate of quality issued by the producer. The producer's certificate confirms that the goods have been checked and comply to the state technical standards – so-called GOST or DSTU. These technical standards are unified at the national level, are developed by the designated state bodies and published as bylaws. Most of the technical standards date back to Soviet times and require reviewing with regards to modern technology and international standards.

Numerous studies triggered by the integration processes of Ukraine into the WTO³⁴ and the European Union³⁵ revealed the urgent need to reform the certification system (IFC 2009, Frota *et al.* 2010). For example, the study commissioned by the IFC and World Bank concluded that the current quality monitoring system hindered economic growth as it imposed high compliance costs on business, harmed competitiveness and created barriers to innovation (Frota *et al.* 2010). The system was finally changed to comply to international standards only in summer 2011³⁶. Therefore, until the end of the fieldwork, the researched companies continued to operate under the old system of certification.

As reported by the researched companies, the system of state certification and quality control was indeed overwhelmingly bureaucratic, inefficient and costly for

³⁴ Ukraine became a WTO member in 2008.

³⁵ Since 2008 Ukraine has negotiated an Association Agreement with the European Union.

³⁶ The Law of Ukraine No 2735-VI 'On State Market Supervision and Control of Non-Food Products' of 2 December 2010; came in force in July 2011 <http://zakon.rada.gov.ua>

producers. For example, the Plant was checked for the quality of the produced cable by various state inspections at least twenty five times a year with each inspection lasting from one to three working days.

Although the old Soviet-type certification and quality control system was outdated and inefficient, it still played a certain positive role in the contract enforcement of the researched companies. First, the system of unified technical standards made it easier to negotiate the terms of contracts. Absolutely all Plant's sales and most of the supply contracts, 82.6% of the Farm's sales contracts and 55% of its supply contracts, and four out of five supply contracts of the Café which I managed to review contained references to Ukraine's state standards (GOST) and technical conditions (DSTU). The universal usage of detailed unified technical standards eliminated most disputes regarding the expected quality of the goods. Additionally, it considerably facilitated the testing procedures.

Second, the certification system was apparently a sufficient guarantor of the quality of the end products that were not further processed. The end products in this study – the cable produced by the Plant and the food products sold by the Café – were not tested either by distributors or by retailers or by consumers. After the cable and the food products left the premises of producers, quality certificates were the only guarantee of quality at each stage of the supply chain. The end users of the goods produced by the Plant and sold by the Café were genuinely satisfied with the quality of these products and certification was seen as a sufficient quality assurance of the end products.

At the same time, the certification system was insufficient to guarantee the smooth enforcement of quality promises in respect to the inputs where the supplies were aimed at further processing rather than for end use. All the inputs were subject to additional quality checks through the sampling and testing procedures discussed below.

Pre-Sale Sampling

While the Plant tested samples of the inputs from the first-time suppliers in its own laboratory before committing to the contract, after the laboratory tests were found to be positive no samples were required for subsequent contracts.

In contrast, the Farm's buyers routinely sampled each single batch of grain bought from the Farm. Given the absence of state certification for grain products, the perishable nature of the goods and wide variations in their quality contingent upon storage conditions, pre-sale sampling was reported as common practice on the Ukrainian agricultural market.

The Farm routinely warned potential buyers of the possible deficiencies in quality and encouraged them to take samples. To exemplify the Farm Owner used the Ukrainian saying: We do this in order that 'their eyes see what hands are taking' [Farm Owner, interview on 8 December 2008]

In this case, the buyers incurred the costs of transportation of samples and expert valuation in the specialized laboratories either owned by themselves (elevators, large trading companies and processing plants) or by the government agency (the laboratory of the State Bread Inspection).

This system, albeit expensive, apparently proved viable for the purposes of contract enforcement. No claims as to the quality of the Farm's products ever arose in the contracts preceded by sampling.

Post-Sale Quality Verification by Buyers

Irrespective of whether the samples were expected or not, and in addition to all quality certificates, Ukrainian buyers were reported to generally check the supplied inputs after delivery.

The most stringent quality control of inputs was demonstrated by the Plant. Absolutely all supplies that were aimed at further producing the cable were subjected to rigorous testing procedures called ‘total incoming control’. The Plant itself subscribed to the procedural quality standards ISO 9001, and the Plant’s laboratory to ISO 17.025. Practically, it meant that the employees of the laboratory took samples from each batch of inputs and tested them in the laboratory before inputs got to the production workshops.

The post-sale verification of quantity and quality of industrial goods was governed by the Soviet Instructions P6 and P7 dating back to 1965.³⁷ It regulates in many details the procedure on inspection of the goods by the buyer. This is perhaps one of the few useful relics of Soviet law that proved viable in the market economy. Although it is not mandatory any more, many contracting parties keep incorporating it by reference into the contracts. For example, these were in absolutely all the Plant’s contracts and majority of the Farm’s contracts.

In the case of doubt about the quality or quantity of goods delivered – whether confirmed by the laboratory tests or not – the Instructions prescribe the inspection of the goods in the presence of authorized representatives of both parties and to draft a single document – the Act of Deficiencies. All disagreements between the parties as to technical issues have to be resolved prior to the signature of the Act of Deficiency. Such disagreements could, for example, concern the questions of whether the measurements were done correctly, whether the deficiency was within the limits of technical standards, and whether the deficiency in quality was caused by the seller or by the incompetent use of the buyer.

³⁷ Instructions No P6 ‘On the Order of Inspections of Quantity of Goods’ of 15 June 1965; Instructions No P7 ‘On the Order of Inspections of Quality of Goods’ of 25 April 1966 <http://zakon.rada.gov.ua>

If the Act of Deficiency confirms no defects, it means that both parties waived their right to raise any quality claims on this batch of goods. If the Act documents the quality defects, the defaulter is obliged by the law and the contract to replace the goods or repair them on site, and to pay the damages and contractual penalties.

Where the quality of cable was questioned by the customer pursuant to Instructions P6 and P7, the Plant was willing to replace the cable of proper quality almost immediately. However, this happened rarely as the absolute majority of claims regarding the deficient quality and quantity of cable turned out to be unjustified. In 2011, out of eight claims regarding deficiency of the Plant's cable, only one was ultimately proved valid and the non-standard cable was replaced.

Quality Verification by External Organisation

Pre- as well as post-sale quality verification could be done through external laboratories, as was the case with the Farm's products. Most of the Farm's grain was checked by the buyers through the State Bread Inspection that has established branches in each region of Ukraine.

Despite being owned by the state, these laboratories have generally gained a reputation for fairness and competency. Furthermore, they were increasingly accredited by international organizations in the international grain trade such as GAFTA³⁸, ILAC³⁹, and SNAS⁴⁰. The interviewees at the Farm reported a sufficient level of trust in the technical expertise and integrity of these state agencies by treating them as the 'highest arbiter' in disputes regarding the quality of grain:

The State Bread Inspection (GHI) is the ultimate arbiter. Although grain elevators have their laboratories and they check the grain when we bring it to the store, elevators may cheat us. If we suspect something wrong we pay

³⁸ <http://www.gafta.com/analysts>

³⁹ <http://www.ilac.org/>

⁴⁰ <http://www.snas.sk/e/>

the services of GHI and they come to verify the quality of stored grain
[Farm Manager, interview on 20 November 2009]

Thus the Acts of the State Bread Inspection were treated by the Donetsk agricultural businesses as an undeniable proof of quality. Consequently, negotiations that followed the quality inspection never disputed the content of the Acts and disputes were always settled.

To conclude, self-enforcing devices protecting buyers in the business relationships of the researched companies included mechanisms of a varied nature such as trade credit, state and producer certification, pre-sale sampling by the buyers, or quality verification by the buyers or an external state-owned verifying organization. Quality assurance in contractual relations regarding highly standardized goods such as cable and food products relied heavily on the state certification and was provided by the sellers. Assurance of the quality of inputs that were aimed at further processing relied more on the sampling and quality verification by the buyers or external organizations. Higher competition in the suppliers' market compared to the buyers' markets entailed a greater availability of alternative suppliers, and thereby enhanced the enforcement capacities of these mechanisms, transforming them into self-enforcing devices. Finally, this study found that collective private institutions such as trade associations were involved neither in the process of technical standard-setting nor in quality verification or monitoring. All the work was done for the business associations by the centralized system of the state certification and state-owned quality verifying laboratories inherited from the Soviet times.

5.3 Conclusions

Consistent with earlier studies in developed and developing economies alike, this research confirms the primarily reliance of Ukrainian businesses upon repeated dealings and various self-enforcing devices as the main mechanisms of contract enforcement.

Repeated dealings were treated by this research as an expectation of continuous transactions with the regular trading partners which ensured the smooth performance of contractual promises by both parties to a contract. Although the conditions of the wider business environment such as a semi-competitive market structure restricted the free choice of this contract enforcement mechanism, the positive effect of repeated dealing on contractual compliance was undeniable.

All the interviewees perceived their business to be ingrained in continuous repeated transactions with regular trading partners referred to as ‘permanent’. More precise estimations reveal that indeed, regular clients and suppliers constituted more than two thirds of all trading partners of the researched companies. An average business relationship was reported to last from five to seven years, although individual transactions were carried out through short-term formal contracts with minimum interdependency, as was shown in the previous chapter of this thesis.

Restricted competition and high uncertainties entailed a higher tolerance to contractual breaches of regular trading partners, including those who continuously delayed payments (‘conditionally blacklisted’) and thereby prompted the preservation of business relationships in most situations. The irrevocable terminations of relationships caused by defective contractual performance were extremely rare at the researched companies, even in the aftermath of the 2008 economic crisis. Furthermore, terminations of business relationships under uncertainty proved to be unspoken, imprecise and almost impossible to

identify. In many cases, businesses were willing to deal with the defaulter again even after court action. Indeed, in one third of court cases in this study, relationships were continued after the judgment was enforced. Clients were said to be never abandoned by the researched companies, but rather put on reserve.

At the same time, limited competition still left some room for manoeuvre for the researched companies. This study documented in Chapter 3 that the new trading partners regularly entered business networks of the researched companies, and that for many relationships there were more than one alternative trading partner. Therefore, within indefinitely stretched informal business relationships, the threat to decline an immediate business opportunity ensured contractual compliance between parties more than the threat to terminate the business relationship. Apart from this, the repeated dealings of the researched companies were motivated by technological need in repeated purchases, the opportunity for profitable trade with the same partners, discounted prices and longer trade credit from them.

Finally, this study demonstrated that repeated dealings shadowed even discrete transactions with first-time trading partners. The parties to these transactions were interested in long-term cooperation with each other, or intentionally broke the first-time transaction into a series of smaller ones to resemble repeated dealings. In this way repeated dealings forcefully induced contractual compliance by the trading partners.

Repeated dealings at the researched companies were always intertwined with self-enforcing devices – technical and financial arrangements such as prepayment and quality assurance schemes, which make the violation of contracts largely impossible.

Self-enforcing devices were found to be different for the enforcement of payment and quality promises. Prepayment was the most powerful self-enforcing device at the

disposal of sellers in non-cash based industries. Prepayment clauses were included in 63% of the Plant's and 53% of the Farm's contracts, whereas the Café's contracts relied on cash payments. In line with the other studies of post-Soviet business, this research confirmed the rule that first-time buyers prepaid their contracts and prepayment requirements were gradually released as transactions repeated.

While most first-time buyers had to prepay for their purchases, prepayment also accompanied at least one fifth of transactions with regular trading partners. In these transactions, prepayment served first of all as a crediting device, as an element of pricing mechanism, a punishment, or a signal of trust to regular trading partner, and only secondarily as a device to ensure contractual compliance. Thus the use of prepayment in the post-Soviet transition does not necessarily indicate distrust or problematic contract enforcement between parties.

Self-enforcing devices that protected buyers guaranteed the quality of goods and services and their timely delivery. Trade credit allowed for a time period for the buyer to examine the goods and to adjust unilaterally their price should defects be identified.

Irrespective of whether the contract was prepaid or not, quality promises in the relationships of the researched companies were additionally self-enforced through the system of state and private certification, pre-sale sampling, and post-sale quality verification by the buyer or state-owned verifying organization. While the assurance of quality in contractual relations regarding highly standardized goods such as cable and food products relied heavily on state certification and was provided by the sellers, assurance of the quality of inputs relied more on the sampling and quality verification procedures provided by the buyers. Quality assurance clauses were present in majority of the sales and purchase contracts reviewed in this study.

To conclude, various combinations of repeated dealing with prepayment or trade credit and quality assurance devices constituted the main contract enforcement mechanisms prevalent in the relational as well as discrete contracting of the researched companies. Reliance upon these private contract enforcement mechanisms prevented the emergence of contractual problems in the first place, and provided effective remedies when the problems still arose.

CHAPTER 6 PRIVATE CONTRACT ENFORCEMENT: SUPPORTING MECHANISMS

Chapter 5 examined the main mechanisms of contract enforcement in the business of the researched companies. Repeated dealings and various self enforcing financial and logistical arrangements constituted the core of the observed contractual pattern. At the same time, this research also identified a role for two other private mechanisms – reputation operating through business networks and personal relations operating through social networks. This chapter explores these mechanisms in greater detail.

The final sections of this chapter illuminate the exceptional contractual pattern involving the state. Although this became evident only in a handful of business relationships in this study, these relationships were much more troublesome for the researched companies.

6.1 Reputation and Business Networks

6.1.1 Reputation as Contract-Enforcement Mechanism

Reputation in substantive terms refers to the information about the trustworthiness of the trading partner, or according to Kreps – ‘the historical facts linked to an actor’s behaviour toward his previous partners’ (Kreps 1990, p. 106). However, for the purposes of contract enforcement the procedural aspect of reputation is more important, i.e. how information is transmitted within the business community and what effects it produces for business relationships. Thus, as a contract enforcement mechanism, reputation may be defined as a way of sharing information about and reacting to the prior behaviour of the prospective trading partner.

Reputation is viewed by most researchers as an important mechanism that ensures the proper enforcement of contracts within business networks and creates durable patterns for private economic arrangements. It provides the ‘glue that permits mutually beneficial transactions to take place, transactions that would otherwise not be made because of their costs’ (Kim 2009, p. 681). It produces the trust necessary for the progress of transactions that contain a risk of opportunistic behaviour. Furthermore, under certain circumstances reputation could serve as self-enforcing device, as it does not involve a third-party decision maker such as a judge, arbitrator or mediator (Scott 2003, Guennif and Revest 2005).

Although a reputational mechanism is activated in relations between two parties without any express involvement of others, it still profoundly relies upon third parties – business organizations or individual members of a business network. Information sharing with, and sanctioning by, the members of a network establish a foundation for reputational mechanisms. Thus, according to Gueniff and Revest, reputation works not in the context of a simple ‘relational embeddedness’ but in a ‘structural embeddedness’ and should be treated as structural rather than strictly bilateral enforcement (Guennif and Revest 2005).

Most researchers distinguish between two aspects of reputation – information sharing and sanctions for wrongdoing. Providing information about those who have cheated does not suffice to deter cheating in future, the injured party must also be able to sanction the cheater by rejecting trading with it, by damaging its reputation or by any other means.

Both reputation information transfers and punishment could be invoked either between two immediate contracting partners or get processed within a wider business network. Therefore, reputational mechanisms can be distinguished as either bilateral or multilateral, and the latter could be either spontaneous or designed (Greif 2008).

Bilateral reputation mechanisms rely upon unsystematic communication among individual businesses through enquiries about the reputation of prospective trading partners. Consequently, uncoordinated bilateral reputational sanctioning is limited to denial of trade with the cheater. Whether other companies would follow the same pattern of rejection is dependent upon their individual enquiries into the reputation of the cheater and individual circumstances.

Multilateral spontaneous reputational mechanisms rely upon certain joint efforts of the network members to disseminate negative information about its members. Provided that the business network is feasible in size, negative information becomes known to all members fairly quickly. Sanctions that are imposed by the network through spontaneous reputational mechanisms entail ‘ostracism’ – organized collective denial of trade by those who were not cheated even at the expense of a profitable trading opportunity.

Gossip is an example of a very basic, spontaneous multilateral reputational mechanism which relies upon networks. In his colourful account of non-contractual business practices, Macaulay described gossip where ‘each has something to give the other. Salesmen have gossip about competitors, shortages and price increases to give purchasing agents who treat them well’ (Macaulay 1963, p. 63). In this way, the salesmen who do not satisfy their customers become:

the subject of discussion in the gossip exchanged by purchasing agents and salesmen, at meetings of purchasing agents associations and trade associations or even at country clubs or social gatherings (ibid., p. 64)

More elaborate, although still spontaneous, reputational mechanisms were illuminated by historical accounts of the community responsibility systems of Maghribi traders (Greif 1989), medieval Europe’s merchant guilds (Milgrom *et al.* 1990), and coalition-like contract enforcement institutions in Mexican California (Clay 1997).

In contrast to spontaneous mechanisms, reputational mechanisms which are intentionally designed manifest themselves through organizations such as business associations and credit rating agencies. They accumulate, store and disseminate reputational information and support collective punishment of the defaulters. According to Greif, reputational sanctioning coordinated through organizations includes fines, membership restrictions and losing of organizational membership that ultimately result in the loss of a trading opportunity and a reduction in profits (Greif 2008). Contract enforcement in modern market economies was demonstrated to rely profoundly upon designed reputational mechanisms which promoted impersonal trade and technological developments (Deakin *et al.* 1994, Burchell and Wilkinson 1997, Greif 2008, Maze and Menard 2010, Dietz 2012).

To conclude, reputation as a contract enforcement mechanism refers to information dissemination and the potential punishment of the defaulter through a business network. At the bilateral level it comprises individualistic enquiries into the creditworthiness of the prospective trading partner and punishment by rejection of the trading opportunity with the immediate contracting partner. At the multilateral level, reputation refers to spontaneous as well as designed mechanisms of collective information sharing and sanctioning by the network members who were not cheated.

Reputation in Transition Economies

Most researchers of post-Soviet transition agree on the increasing importance of reputation in business (Johnson *et al.* 2002, Radaev 2004, Frye 2005, Vinogradova 2005, Pyle 2006a). The demand for multilateral reputational institutions in the post-Soviet context was taken for granted by many researchers. However, scarce empirical evidence does not allow for an unambiguous conclusion on the question whether Russian business people were prepared

to rely on designed multilateral reputational mechanisms to punish the defaulters collectively.

For example, one of Hendley's case studies on Russian business examined the rationale behind the termination of the business relationship. She concluded that 'the decision to fire SK as a customer was made on a bilateral basis by each of its suppliers and was not a sanction for violating community norms' (Hendley 2009a, p. 37). In contrast, the 2005 experimental survey of Russian enterprises by Frye demonstrated that 'interviewees were fairly confident that other firms would punish a firm with a bad reputation' (Frye 2005, p. 26).

Whether businesses were seen as willing collectively to sanction the defaulters or not, the major obstacle for multilateral reputational punishment resulted from the deficiency of informational flows. According to Frye, these deficiencies did not allow businesses to learn about negative reputational information in the first place (Frye 2005). Pyle showed that business associations increased the flow of reputational information when the business partners were located in different cities; yet in the competitive markets the value of business associations in the spreading of reputational information was minimal (Pyle 2005, p. 2).

Screening of the prospective trading partner through an examination of the incorporation charter or tax certificates before signing the contracts and enquiries of the network members remained the major sources of reputational information among Russian small and medium companies in the Vinogradova study (Vinogradova 2005, p. 108-125). These sources were shown to be costly and not completely reliable (Hendley 2001).

To conclude, research on reputation in the post-Soviet transition indicates some flaws in both the information sharing and sanctioning functions of the reputational

mechanisms. The following sections of this chapter attempt to better understand how detrimental the above flaws are for contract enforcement in contemporary Ukrainian business.

6.1.2 Reputation at the Researched Companies

The following sections explore the limitations of reputational mechanisms, such as gossip, network enquiries, reputational screening and branding identified in business relationships of the researched companies.

Limited Reputational Gossip

Considering that the semi-closed markets in which the researched companies operated did not preclude at least some free choice of trading partners, all the three researched companies proved to be highly concerned with their reputation. They were conscious that a positive reputation was not acquired over night and needed time and investment, therefore reputation was ‘earned’ and ‘built up’ with the years.

The Plant had an express policy towards ‘building up a positive and honest’ reputation at least before it fell into the trap of the 2008 financial crisis. The Plant’s 2015 Strategic Plan of Development aimed at enhancing its reputation through better client satisfaction, increased speed of transacting and better contractual compliance. During this research the Plant was perceived as holding the reputation of a ‘tank’ – reliable but slow.

By the same token, the Farm was quite confident that it possessed a positive reputation within a business network because it ‘had never cheated anyone’ (*kidat*) and was always honest about the quality of its agricultural products.

The Café Owner was the most proud of her positive reputation:

Avtoritet (image) is very important. First years I worked for my *avtoritet* and now it works for me [Café Owner, interview on 7 October 2008]

Her reputation was earned by hard work during the last fifteen years which was evidenced by many letters of thanks (*blagodarnost'*) from the City Council. It enhanced her business opportunities and consequently the number of business relationships (Case No 3.5 Red Bull, Appendix 3).

Thus interviewees were fairly concerned about their reputation among trading partners and the wider business community. At the same time, they seemed to presume that reputational information was disseminated on its own and did not require any directed efforts. This channel of reputational information most closely resembled the gossip networks researched in many contract enforcement studies in developed and developing economies alike.

However, interviewees in this study rejected the words 'gossip' and 'rumours' to label circulation of information within their business networks. Instead they used such expressions as circle of acquaintances (*krugovyye znakomyye*), gypsy mail (*tsyganskaya pochta*) and word of mouth (*narodnaya molva*). Yet, by one way or another, in the semi-closed business networks where 'everyone knows everyone', basic reputational information about network members became known to all others without specific efforts. Therefore this study builds upon the concept of gossip.

Gossip in the networks of the researched companies relied upon the high turnover of managerial personnel. It was particularly noticeable in the food retail industry. According to the Café Owner:

I work with five large enterprises. If I do not pay all of them at once others will learn because managers communicate with each other, they often change their jobs [Café Owner, interview on 7 October 2008]

Within the Plant's and the Farm's networks, gossip was supported by occasional informal gatherings. The State Administration – local government of the district (*rayon*) – used to organize annual informal meetings of the local farmers devoted to the Day of the Agricultural Worker festival. These were genuinely cultural events held in the restaurants and paid by the farmers to celebrate the end of the harvesting season.

The meetings of the cable producers were also organized at least once a year by one of the cable-producing plants – Berdyansk – in the form of the seminars on technical issues of cable production and innovations. Although networking was not the primary goal of these seminars, they were reported to 'develop loyalty' between buyers and suppliers. The Plant's supplier reported that:

After the presentations [at the Berdyansk seminars] we have informal gathering and a lot of information is transferred from one to another. We also share information about our hobbies. I learnt at the seminar that one client is fond of photography as myself. I gave him a few books and advice; now he is my client forever [Owner of the Small Innovation Firm, the Plant's Supplier, interview on 13 October 2011]

Thus both types of meetings enhanced the operation of gossip within the networks of farmers and cable producers.

Finally, gossip in the networks of the researched companies relied on communication with the local state officials in charge of certain sector of business. For example, the Farm maintained strong personal relations with the Department of Agriculture which acted as gatekeeper at the local agricultural market and *inter alia* provided the Farm with information on the reliability of local suppliers.

Increased use of Internet by Ukrainian businesses in recent years appear to have only marginally contributed to the dissemination of reputational information within local business communities. Beautifully designed websites of prospective trading partners served rather as signals of reliability and evidence of the company's investments into non-salvageable reputational assets. No direct information about the trustworthiness of businesses, such as blacklists posted in the Internet or disseminated through Internet forums, was reported to be ever used by the researched companies.

Gossip remained the major channel for dissemination of reputational information within the networks of the researched companies. Yet it proved to have a few notable specific features that limited its outreach.

First, purposive dissemination of any type of information about the trading partner was reported to be minimal. The following conversation with the Farm Owner is indicative in this respect:

When a trading partner hurts me I spread rumors that they are cheaters. Q: Do you spread them on purpose or answer the questions from your other partners? A: No, I answer questions, I do not call others on purpose to spread negative image. I could have spread it on purpose but I am lazy. Q: Have you ever seen that others spread a negative image? A: No, it is only answering the questions [Farm Owner, interview on 7 December 2009]

Thus, within the gossip networks of the researched companies, the likelihood of others learning about the dispute was linked *not* to the efforts of the injured party but rather to the number of people involved in the dispute. The Farm's Newholland Combine Case (No 2.6, Appendix 3) illustrates the point. In this painful dispute the emotional pressure at times was particularly high and the Farm Owner looked determined to take revenge and spread negative information about the negligent supplier. When interviewed, he shared with me his threats to use the local State Administration to disseminate the letters about unsatisfactory quality of the machines by this supplier among the local farmers. The Farm

Owner even filmed on video one of the inspections of the combine by the supplier's mechanics. Yet he never actually followed through on the threats. Nevertheless, the Farm Owner claimed that:

the whole neighborhood (*rayon*) got to know about the dispute anyway because I involved many people – state officials such as the chief engineer and the chief agronomist of the *rayon* and my father [well known and respected businessman]. Furthermore, I told already all the competitors about the dispute with the Newholland because they asked themselves. And I told anyone among other things if the conversation touched on a similar matter [Farm Owner, interview on 7 December 2009]

The second restriction endemic in gossip networks of the researched companies concerned their semi-closed structure. Some business networks were more closed than the others and did not allow the leaking of information to outsiders. For example, in contrast to the Farm's network, reputational enquiries within the network of cable producers and consumers were restricted solely to *known* members of this network. Interviewees at the Plant put it very clearly:

We are always happy to share information with a *known* partner about our clients. We may share negative information that this and that client is not serious. But we tell this only to the *known* partner. We will not tell this to someone we do not know and only on request. We do not spread rumours [Sales Manager B, the Plant, interview on 13 December 2010]

Sometimes we can reveal information about untrustworthy businesses to our *partners, whom we trust*, but still we do not disclose the reasons why we do not work with them [Vice-Director for Economic Security A, the Plant, interview on 10 December 2009]

Third, there was a definite reluctance of the interviewees in this study to reveal *negative* information about the existing trading partner as compared to *positive* reputational information. Although information on quality was more readily revealed, information on creditworthiness and diligence in payments was saved only for close friends. This finding is consistent with the Pyle's observations that Ukrainian businesses readily talk to competitors and each other about technology and product design, but hardly about their

trading partners (Pyle 2005, p. 8). According to the interviewees from all the three companies, rumours about the bad reputation of the businesses did not spread within their networks:

Coca Cola tells people only good things about me. Information about a negative reputation went around in the 90s when it was the time of overt opportunism (*kidnyaki*). Now these firms are gone [Café Owner, interview on 4 November 2008]

Usually rumours about the bad reputations of others do not go around. It happens perhaps regarding quality when we choose chemicals. People do not spread rumours about spoiled reputation on purpose. I do not know such cases. Oh, well perhaps one – someone told me once that one this specific supplier is not good and warned not to buy from him but I did not remember the name of the company [Farm Manager, interview on 4 November 2010]

We do not spread negative information about a debtor; this is black PR and black competition. This is revenge. We do not use these methods in principle. Other enterprises do use – read the yellow press – but this is illegal [Vice-Director for Economic Security A, the Plant, interview on 10 December 2009]

I have not encountered dissemination of negative information (*podryvnaya informatsiya*) about the partners. Once it was information about the enterprise that produces cable of low quality rubber [Head of the Legal Department, the Plant, interview on 5 November 2009]

We do not need to transfer negative information about cheaters. If he cheated someone, it does not mean that he will cheat you. For example, M. – the state-owned coalmine owes everyone but pays me [Owner of the Small Innovation Firm, the Plant's Supplier, interview on 13 October 2011]

Perhaps, because the intentional spreading of negative information about trading partners was seen as inappropriate by the interviewees in this study, they refused to label information exchanges within their networks as gossip or rumours.

Thus the reputation mechanism prevalent in the business networks of the researched companies rested upon the restricted practices of collective gossip. A strong opposition was evident in respect to the *purposive* dissemination of *negative* reputational information, especially about the payment discipline of trading partners.

This becomes understandable when we recall that contract defaults as such were not a frequent phenomenon in the relations of the researched companies, thus there was little negative reputational information to disseminate. As it was shown in the previous section of this chapter, the uncertainties of the wider business environment entailed the possibility to renew cooperation even with a once-blacklisted trading partner. All of these rendered the purposive dissemination of negative reputational information largely unnecessary in the first place. Only in the last instance, the costs of dissemination efforts were reported by the interviewees to restrain them from the active spreading of negative rumours about trading partners.

Decline of Enquiries and Reputational Screening

In the face of limited gossip, this study documented the surprisingly minimal role of reputational screening of prospective and existing trading partners at the researched companies.

Given the standardized nature of trade, the Café Owner did not need to screen her prospective vendors for quality of the goods because it depended upon the producer and not the vendor. Furthermore, high competition among suppliers largely excluded the incompetent work of trade agents who brought the goods on spot. Thus the Café's suppliers were seen as not requiring any screening prior to the initiation of the business relationship.

The Farm never had any formal procedures of reputational screening. It did not check the creditworthiness of prospective buyers whatsoever. It was deemed time consuming and unreliable and was replaced by prepayment. The quality of supplies to be purchased was of more concern to the Farm. This was checked through individual enquiries of the existing trading partners, information from the websites of prospective

counterparties, and enquiries of the state agencies – the State Seeds Inspection and the local State Administration which informally shared their knowledge of business reputations.

In contrast to the Café and the Farm, screening for reliability of the counterparties was built into the managerial routine of the Plant. First, operational level managers had to ensure the reliability of the potential trading partner themselves. In most cases information was supplied through gossip and the managers reported to know generally all the potential clients on their market. Only in exceptional cases were reliability checks done through bilateral enquiries. The logic of such checks was summarized by one of the managers:

If I want to know something about a potential client, I call him and ask ‘what is your parent company (*golovnoye predpriyatiye*)?’ Then I call the parent company and enquire to them about the guy. Then I ask the guy what partners he has worked with and call these people. And so on – through the chain (*po tsepi*) [Sales Manager B, the Plant, interview on 1 August 2007]

Second, before the contract was signed, the operational managers of the Plant were obliged to obtain copies of certain corporate documents from their counterparties. The copies of at least five corporate documents were requested for the signing of the annual master part of the framework contracts, and were retained for the life of the contract.⁴¹

Third, the whole department of the Plant – the Department for Economic Security – was in charge of reliability screening at the Plant. The signature of the Vice-Director for Economic Security on the draft contracts signified that the respective checks had been carried out and contracting with this trading partner was safe.

⁴¹ The full list included the copies of the following documents: (1) the title page of the charter of incorporation of the company; (2) excerpts from the charter containing information about the types of business activity of the company and authorities of the official who will sign the contract; (3) the document confirming the appointment of the chief executive officer (CEO); (4) first page of the passport of the CEO; (5) certificate of the state registration of the company; (6) certificate of the company as a tax-payer of VAT; (7) certificate with the number of the company in the Single Registry of Companies of Ukraine (EGRPOU); (8) in case the contract is signed by any other person than the CEO, the document confirming their authority to sign the contract; (9) in the case the contract is signed by the person other than CEO, the first page of the passport of that person.

The Department for Economic Security of the Plant claimed to screen all the prospective trading partners for negative information through the Internet. The Head of the Department kindly provided me with the dozen weblinks that they use for this purpose. Half of them did not work when I tried them; the rest were open access government data bases and privately compiled catalogues of enterprises.⁴²

In the face of the importance attributed to the security checks by the Economic Security Department, it was a surprise to discover that these checks were considered by many employees of the Plant, including the lawyers, as a waste of time and as a dead organizational rule. The Head of the Legal Department reported:

I really doubt that the Department of Security screens all the clients. It never ever happened that they had cancelled a transaction for the unreliability of the client that they had discovered [Head of the Legal Department, the Plant, interview on 11 October 2011]

Operational level managers claimed that the screening by the Security Department was losing its importance and was done mostly formalistically through the checks of the basic documents of the counterparty before the contract was signed.

Taken together, the interviewees in this study confirmed their unwillingness to invest in the reputational screening of prospective trading partners. The general attitude was encapsulated by the dialogue with one of the Plant's supplier:

⁴² <http://www.bankrut.gov.ua/> Official Data Base of Bankruptcy Proceedings initiated in commercial courts of Ukraine (fee based since 2009); <http://www.ukrstart.com><http://www.ua-region.info><http://www.cis.trifle.net/> Unofficial catalogues of Ukrainian and CIS Enterprises, include contact details and basic products/services (free public access); <http://www.stockmarket.gov.ua><http://www.smida.gov.ua/> Official Data Bases of Ukrainian public stock companies, include financial and accounting information, information on debts and bank loans (free public access); <http://www.reyestr.court.gov.ua/> Official Data Base of court judgements of commercial and other courts of Ukraine since 2006 (free public access); <http://sta.gov.ua/control/uk/checktaxpayers> Official Service of the State Tax administration that provides information about initiated bankruptcy proceedings, liquidation, absence from legally registered site, failure to renew information in the governmental registry of enterprises (free public access).

We do not really screen. We find the link in the Internet and begin to work with them. Q: Do you check Internet data bases – for example the website of the Tax Inspection? A: It does not really help. Q: Do you call your colleagues to enquire about the potential trading partner? A: No [Owner of the Small Innovation Firm, the Plant's Supplier, interview on 13 October 2011]

What was the rationale for the decline of reputational screening? First, prepayment was seen by the interviewees as the most reliable contract enforcement mechanism and this made enquiries into the reputation of a prospective trading partner meaningless. The Plant's buyer stressed:

When we sign the contracts we only exchange the documents of our organizations; we do not use the Internet, and do not call anyone to enquire. We better ask for prepayment from the new clients. We can always say when the firm is fly-by-night and always request for prepayment from them [Manager of the Cable Trading Company, the Plant's Buyer, interview on 19 October 2011]

Second, where a large corporation with universally recognisable brand names – foreign as well as owned by Ukrainian oligarchs – becomes a prospective trading partner, reputational screening is limited by verification of the agent's identity. Thus branding turned out to be a powerful reputational mechanism capable of replacing reputational screening; this is discussed in more detail in the following section.

Third, this study revealed that even trade credit could be offered to an unscreened first-time buyer provided it purchased the smallest possible batch of the goods through instalments. Thus reputational screening could be substituted by the mechanism of 'trading with small amounts' which transforms one-off transaction into repeated dealings.

Finally, because some business relationships were dominated by kickbacks from suppliers (*otkat*) which will be discussed later in this chapter, reputational information was deemed irrelevant in these cases and was frequently disregarded in favour of informal relations. The Head of the Plant's Legal Department shared her frustration:

I used to check the public data base of bankruptcy but it really did not make any sense and I stopped doing it. The coalmine may go through bankruptcy proceedings but when the sales managers have appropriate personal relationships with them and have already brought them *otkat*, the contract is signed anyways. [Head of the Legal Department, the Plant, interview on 18 October 2011]

Thus while the Plant was at least formalistically screening all the prospective buyers and sellers for their reputation, the small and medium sized companies did screening only of selected suppliers for quality of goods. They possessed neither resources for the reputational screening of creditworthiness of the buyers, nor apparently the need for it. They preferred to exchange corporate documents, initiate contracting with small amounts, request prepayment or rely upon kickbacks from suppliers rather than spend their time screening and making bilateral enquiries.

Increased Reliance upon Corporate Names and Branding

According to Tadelis, a firm's name symbolizes its reputation; it is considered to be one of its most valuable assets which attracts clients and leads to larger profit margins (Tadelis 2003). Brand names were primarily treated as devices to ensure the high quality of consumer goods (Klein and Leffler 1981), yet brand names could also enhance the contractual discipline of the brand name holder. A brand name could signal the credibility of the prospective trading partner through visualizing its sunk investments into capital assets, advertising of goods and services, elaborate store fronts, charitable contributions, and community services.

In line with the study of Ukrainian agricultural business (Gagalyuk and Hanf 2009, p. 113), this study reveals that the large international corporations which were active on the Ukrainian market were treated by the interviewees as the 'most desired' trading partners. The examples included agricultural producers and marketers Cargill, Bunge, and Kernel;

producer of chemicals Bayer, and technology company Siemens. A few large Ukrainian companies, namely Metinvestholding Group owned by oligarch Rinat Ahmetov, were also named along those who managed to develop their brand names through structuring business under western corporate standards; massive investments into charitable activities and improvements in local communities (Markus 2012).

Apart from supplying products of superior quality, brand name holders promoted the highest standards of contract enforcement. As reported by the interviewees in this study, they ‘worked only under written contracts’, have ‘everything done neatly (*chotko*)’, and paid contracts ‘day in day’ (*den’ v den*). Owing to their enhanced market position and bargaining power, the brand name holders were often tough negotiators but as soon as they signed the contract, it was executed ‘as a clock’. Furthermore, they committed to never resort to illegal means of doing business, at least in their relationships with the trading partners. According to the interviewee of this study:

The companies owned by oligarchs work the best on our market. They are more open and transparent. They do not use *otkat* (kickbacks from suppliers) and administrative resources [Manager of the Cable Trading Company, the Plant’s Buyer, interview on 19 October 2011]

Thus trading with these large foreign and Ukrainian enterprises with well-recognized names was seen as a matter of prestige by Ukrainian companies. In order to attract orders from the brand name holders, the researched companies were eager to let down their guard of prepayments and extend trade credit from the very first transaction. Official policies of many brand name holders against prepayment were well compensated by the large volumes of trade with them. The Plant for example was trading under unusually long thirty-day trade credit terms with the Ahmetov’s enterprises, even when in financial distress, and made all possible efforts to retain the well-known client.

Reputation of the brand name holders was widely known to all the interviewees.

According to the interviewees, it did not require any reliability screening:

This year we were approached by the sister company of Siemens. We eagerly sold them. You know, Siemens does not need to be checked for reliability [Sales Manager A, the Plant, interview on 8 December 2009]

Minimal screening through the pre-contractual exchange of corporate documents and enquiries of the parent company in these cases was aimed only to verify the identity of the agent offering to sign a contract on behalf of the brand name holder.

In conclusion, corporate or brand names of the powerful players in the respective markets of the researched companies served as a reputational contract enforcement mechanism which substituted prepayment and reputational screening. Yet it should be borne in mind that these were exceptional few cases.

Main Sanctioning Mechanism: Denial of Bilateral Trade

Given the limitations of reputational informational flows through uncoordinated gossip and occasional individual enquiries of the network members as discussed above, the concerted collective punishment of cheaters through business networks of the researched companies was problematic. When the business community as a whole is not informed of the opportunistic default, the denial of a trading opportunity between two trading partners remains the main sanctioning device. And this was the case in the business networks of the researched companies.

None of interviewees in this study reported to have ever taken part or even heard of ostracism or any type of collective punishment in Ukrainian business. Moreover, a sense of collective punishment was completely missing in the discourse of the interviewees. They did not rely on repressive language of ‘punishment’ and ‘sanctions’ when they were talking

about reputation. As the Farm Owner explained, individual for-profit considerations overweighed prospects of collective punishment of the cheaters:

I do not believe that if everyone learns about one default of one partner, they stop working with him. Everyone cares only of own profits. If the deal with the defaulter is profitable they would spit at others (*plevat' na vsekh*) [Farm Owner, interview on 9 December 2010]

Taking into account the fierce competition for buyers and the pervasiveness of prepayment, such a collective reputational sanction as exclusion from the network was by definition unworkable in the markets that I studied. In the aftermath of the 2008 economic crisis the Plant was for example prepared to sell its cable to anyone who paid upfront, irrespective of their reputation. Informal annual meetings of the farmers and the cable-producers did not expressly exclude any network members and were aimed at covering all the players at the market.

To sum up, the deficiency of an informational flow definitely impeded coordinated multilateral reputational sanctions within the networks of the researched companies. Yet, even provided that reputational information was perfectly available to all the network members, there were still doubts that they would coordinate to collectively punish the cheaters. Dissemination of reputational information and the collective punishment of the defaulters inevitably required the establishment of organizations such as trade associations. The following section investigates whether any signs of such organizations or demand for them were visible in the networks of the researched companies.

In Search of Designed Reputational Mechanisms

It is a commonly acknowledged fact that collectively designed private institutions – business associations, credit rating agencies, permanent arbitration panels, internet

companies that publicise reputational information in certain segments of business etc. – are important constituents of modern complex market economies (Greif 2008).

Notwithstanding all efforts to identify such institutions within the networks of the researched companies, this research has got only a slight indication of demand for them. Non-governmental business associations were never mentioned by the interviewees in the context of reputation or quality assurance schemes. When the interviewees were directly asked about the role of business associations in spreading reputational information, the answer was always negative.

This study revealed that trade and professional associations in Ukraine should be treated with caution. It turned out that some professional organizations where the researched companies held membership were phony. They were established by governmental agencies with the purpose of extortion from businesses or as a pure formality. For example, the Farm Owner did report that the Farm held membership in one regional association of agricultural producers because it paid fees monthly. However, he was not able to recall even the name or any other details of this association.

A similar organization to ‘support’ small business under the auspices of the City Council was consulted by the Café Owner during her litigation against the state authorities but no assistance has been rendered.

The Plant was more engaged in business networking at the national and international levels. It was the member of the International Wire and Machinery Association UK⁴³ International Association ‘Elektrokabel’ from Russia⁴⁴, and Association ‘Ukrelektrokabel’ from Ukraine. However, the aim of these associations was to enhance communication on technical issues between the members, to provide information on

⁴³ <http://www.iwma.org/>

⁴⁴ <http://www.elektrokabel.ru/>

markets and to lobby the government, but not to transfer reputational information or to punish cheaters.

Ukrelektokabel was the main business association for Ukrainian cable producers with all five Ukrainian cable manufacturing plants as the members. Yet, as of May 2012, the Association has not got a website, let alone any publicly accessible data bases or Internet forums. The Vice-Director for Marketing of the Plant revealed that Ukrelektokabel was active in lobbying the government for protective measures against the smuggling of low quality Turkish and Chinese cable into Ukraine. When I asked whether the members of Association shared any information about disreputable suppliers or clients, the Vice-Director answered that it had not occurred to them.

In contrast, the Russian Association of cable producers, of which the Plant was member, was far more active in the dissemination of reputational information than its Ukrainian counterpart. The Russian association has set up an Internet forum for cable producers of Russia and CIS – www.ruscable.ru. It offered an example of a highly organized informational resource that *inter alia* contained discussions of disreputable trading partners. In contrast to the Ukrainian pattern of silence about dubious business partners, Russian cable producers posted the names of supposed cheaters and freely asked each other the question ‘Who knows company X?’ Although Ukrainian cable producers were formally represented at the forum, I was not able to identify there a single piece of information related to an unscrupulous Ukrainian cable manufacturer or supplier. The interviewees at the Plant confirmed that they did not use Ruscable.ru or any other Internet forum for reputational screening. They explained that:

Most negative information in cable business is spread by the forum at Ruscable.ru. But we do not do this because in order to write something negative there you need to check it for 100% and we do not have time for this. Who does it? Well, there are always discontented (*nedovol'nyye*)

[Vice-Director for Economic Security A, the Plant, interview on 10 December 2009]

No, we do not have anything like Ruscable.ru. We prefer life communication. I am not sure that if someone organizes the Internet forum people will use it. We do not need it [Owner of the Small Innovation Firm, the Plant's Supplier, interview on 13 October 2011]

Instead of formal business associations, the Plant picked up reputational information about prospective trading partners at the trade exhibitions and during seminars organized by the Berdyansk cable plant. However, the interviewees gave very negative feedback when I suggested that these seminars and informal gatherings could be transformed into a formal business association. The reaction of the Plant's supplier illustrates the point:

There is no sense in business associations. Some time ago, one association asked me to join them. They promised to place adverts about us on their website. But in turn we have to pay membership fees regularly. It does not make any sense for us. These are empty fees. You cannot unite wolves [competitors] in one organization. Q: Your Berdyansk seminars resemble a business association – why not to register it officially? A: No. Who needs this bureaucracy? No, I do not like this idea [Owner of the Small Innovation Firm, the Plant's Supplier, interview on 13 October 2011]

In a similar way, the networks of the Farm resisted any organizational forms of interaction between the members. Instead, the agricultural market of the Farm relied upon informal links with the state agencies which appeared to be quite active in providing unofficial information and consulting services to local agricultural businesses.

The Farm often reported referrals to enquire about suppliers' reputation to two state agencies – the State Seeds Inspection and the Department of Agriculture of the District (*rayon*) State Administration. The Farm maintained regular personal contacts with the officials of these agencies through personal communication enhanced by inexpensive gifts. As a result it enjoyed first-hand reliable information about the best quality providers of the seeds, chemicals and agricultural machines. The Farm Owner explained:

Our Manager has an acquaintance at the State Seeds Inspection. Producers of seeds give samples to them to verify the quality, so they know the quality. They provide us with information unofficially. The Manager brings a bottle [of alcohol] to them occasionally. He has personal relations there and we fully trust their information [Farm Owner, interview on 17 July 2007]

Furthermore, the suppliers of chemicals, agricultural machines, spare details, fuel and other agricultural inputs were reported to enquire to the local departments of agriculture about local farmers. A few trading partners of the Farm were recommended through this referral system. According to the Farm Owner, it offered the only reputational reference for initiation of the relationship, for example, with the first-time petrol supplier in 2009:

We did not screen our new supplier of petrol Azovkontrakt. It has been selling to the half of the district (*rayon*) for years. The Head of the *Rayon* Department of Agriculture has been advising us for a long to buy from them. And this year they had very good prices, so we gave it a try and it worked out well. I have not met them personally but have easily initiated bank transfer of UAH 400,000 to them [Farm Owner, interview on 26 December 2011]

At the same time, the interviewees at the Farm stressed that although information originated in the state agencies, the nature of the link with the officials was unofficial, personal, individualized, long-standing and consequently trusting. Apparently, owing to these features, the referral system through state officials was sometimes flawed. Their recommendations were always one-sided – although they attested to the reliability of the businesses that they recommended, they did not check the reliability of the enquirers. At least once such a referral caused a problem for the Farm.

Agricultural enterprise Makeyevka Mill contacted the local Department of Agriculture and was referred to the Farm. The Mill asked for harvesting services with the Farm's combines. In the rush of the harvesting season the Farm treated the referral as a sign of reliability and did not screen the Mill any further. Sadly, the Mill soon went into

bankruptcy leaving behind a dead debt (Case No 2.4 Makeyevka Mill, Appendix 3). Thus the referral system through the state agencies did not completely guarantee full contractual compliance and was apparently prone to abuse owing to the pervasiveness of personal connections and non-transparency.

To sum up, the multilateral coordinated reputational institutions were largely absent from the contract enforcement picture of the researched companies. It was safe to conclude that business associations played no role in the dissemination of reputational information and sanctioning the defaulters. At the same time, the minimal demand for multilateral coordinated institutions still became evident in this study. However, it did not manifest itself in the establishment of the business associations to disseminate reputational information. Instead, it materialized in the informal communication of the market participants at exhibitions and seminars (the cable market) and in an unofficial referral system through personal connections with state officials (the agricultural market). In both cases, mechanisms of reputational transfer were clearly based upon personal connections and individualized bilateral trust, but not upon formal organizational structures. Therefore, they contributed to the gossip rather than promoted multilateral coordinated reputational mechanisms. The idea of a concerted collective reputational exchange and sanctioning was not embraced by the interviewees – it was seen as unnecessary within semi-closed markets dominated by the repeated dealings and prepayments.

6.2 Personal Relations and Social Networks

6.2.1 Various Dimensions of Personal Relations in Business

Organizations are a legal fiction and complex structures made up of people, therefore, according to John Browne, CEO of British Petroleum, ‘you never build a relationship

between your organization and a company. [...]. You build it between individuals' (Adobor 2006, p. 474). Impersonal characteristics of the company such as its position on the market and its managerial strategy are intertwined with personal characteristics of employees such as integrity and communication skills.

The research on business networks has differentiated between strong (friends) and weak (acquaintances) ties in the network based on criteria of reciprocity. In his research of business networks in Russia, Batjargal specified the meaning of friend (*drug*) as 'those with whom you have non-reciprocal and altruistic relationships', and the meaning of acquaintance (*znakomyy*) as 'those with whom you have reciprocal relationships' (Batjargal 2003, p. 545). The importance of the above distinction in the context of Russian post-Soviet transition was highlighted by Hendley:

Most Americans could distinguish between their friends and acquaintances if pressed, but the dividing line would be somewhat murky. For Russians, the difference between an acquaintance (*priyatel'* or *znakomyy*) and a friend (*drug*) is profound. With friendship comes an almost bottomless trust that stands in contrast to the guardedness exhibited with acquaintances (Hendley 2011b, p. 393)

Thus, based on the above distinction, a business network which comprises trading partners – acquaintances – are contrasted with a social network consisting of friends and relatives.

Yet the borders between two types of networks are fluid. Friends and relatives may become contracting partners, and contracting partners could eventually become friends. Family and friendship links that precede a business relationship originate outside the primary sphere of business – in social networks of individuals. Personal sympathies and eventual friendships that arise following the initiation of a business relationship require long-term fruitful cooperation and some experience in positive personal interaction.

Business relationships between two companies that rely more on impersonal characteristics of the companies and on weak ties (acquaintances) can often survive the departure of individuals who initially established the relationship (Sako and Helper 1998). Individuals may come and go but the relationship remains in place. Conversely, a relationship based on personal sympathy and the strong friendly ties of a social network would rather follow the person.

Personal relations with the friends and relatives, as well as with the trading partners who became friends in the course of business, assume informal face-to-face meetings often in a social settings outside the business; while less personalized inter-organizational relations are based on formal meetings, telephone contacts, and an avoidance of overly friendly interactions.

Social networks that eventually grew up into stable business connections have been extensively studied by researchers both in historical and contemporary perspectives. The East Indians in East Africa, the Syrians in West Africa, the Chinese in Southeast Asia, and the Jews in Middle Age Europe were ethnically homogeneous trading groups that monopolized trade by erecting barriers to entry into the business. These barriers were based upon network membership criteria such as ethnic identity, dietary restrictions, and religious rituals (Cooter 1984).

These networks were primarily characterized by their exclusionary power – the power to ostracize cheaters to the extent that makes their business impossible. These types of networks based upon social connections were demonstrated as detrimental for economic growth in developing countries unless they are of a relatively large size (Cooter 1984, Kali 1999). Despite its effectiveness in enabling business to cooperate, the excessive personalization of business relations, documented by the research of contract enforcement

in Africa, was believed to lead to the fragmentation of the economy into networks and restrictions of competition (Fafchamps 1996, p. 444).

In contemporary developed economies, limited personal relations, although not possessing exclusionary power, were demonstrated to matter nevertheless. In stable business networks, a reliance on repeated dealings with the same trading partners becomes inevitable in many cases. Day-to-day continuous interactions personalize exchanges by establishing a common memory that increases the diffusion of routines and facilitates the resolution of contractual problems between trading partners. In his seminal essay on non-contractual relations in business Macaulay notes that:

Top executives of the two firms may know each other. [...] They may know each other socially [...]. Even where an agreement can be reached at the negotiation stage, carefully planned arrangements may create undesirable exchange relationships between business units. Some businessmen object that in such a carefully work out relationship one gets performance only to the letter of the contract (Macaulay 1963, p. 63-64)

According to Sako, where manufacturers are particularly concerned with the quality of inputs as well as low costs 'there may be benefit in replacing faceless competition in the marketplace which may breed low trust by particularistic rivalry which preserves the high trust of all types' (Sako 1992, p. 245). Recent marketing research demonstrated that social bonds between buyer's and seller's key contact employees enhances the buyer's loyalty, trust and satisfaction toward the seller, and the buyer's perceptions of the seller's service quality (Schakett *et al.* 2011).

Thus an excessive reliance on personal relations in business to the exclusion of free entry into the network is detrimental for economic growth. Yet some personalization of business relations in competitive markets may be desirable, as personal relations lubricate the transfers of reputational information within business networks and increase trust.

This section of the study attempts to grasp the general level of personalization in the relationships of the researched companies. It explores the question whether the fact of affiliation in the same family or social network could serve as a powerful incentive for contractual compliance.

Personal Relations in the Post-Soviet Transition

It is generally believed that a cultural predisposition to rely on informal ties in business paired with institutional imperatives ‘necessitate the extensive reliance on personalized exchange relationships’ in the transition to a market economy (Peng 2002, p. 260). Earlier researchers of the post-Soviet transition documented unusually heavy investments in social networks (Nashchekina and Timoshenkov 2002). According to Batjargal, who researched business networks in Russia:

The legacies of communal cultural traditions and the Soviet economic system, and the extreme economic chaos prevalent in contemporary Russia make flows of goods and services through personal networks a dominant mode of exchange among organizations and individuals (Batjargal 2003)

Hendley and others have found that there is a personal dimension to the relationships with contractual counterparts in 50% of transactions. Many managers in their survey believed that ‘the limited resources of their trading partners tend to go towards paying debts to companies to whom a personal obligation is felt’ (Hendley *et al.* 2000, p. 638). At the same time, the Hendley and others survey found that informal sauna meetings were losing their importance in Russian business by the end of 1990s.

More recently, researchers began to document the monetization of relations among business people. Personal relations based on family and friendship links were demonstrated to have largely lost their relevance. For example, a survey of Russian small business indicated that up to three quarters of the entrepreneurs did not need any longer to turn to

friends and close business partners when starting their venture (Malieva and Chepureenko 2004, p. 79). Similar results were obtained in the survey of Russian businesses by Radaev:

Strategic alliances are increasingly built upon not personal and long-term friendships and kin relationships but more upon recognition of the professional and managerial skills and business reputations (Radaev 2004, p. 16-17).

At the same time, personal relations that originated in business networks and relied on the continuous positive interactions of businesses were demonstrated to have retained their importance in contemporary Russia (Malieva and Chepureenko 2004).

The findings of this research are in line with the above studies by documenting the clear decline of the friends and family ties in economic exchanges toward less personalized relationships with trading partners, even in long-term continuous interactions.

6.2.2 Many Functions of Personal Relations in Ukrainian Business

Family and Playmate Connections

While this research did not identify any business relationships at the Plant and the Café that were based upon family or playmate connections, the Farm had these type of ties laid down in the foundation of its business.

The Farm Owner was a son of the locally well-known businessman and agricultural expert, a former member of the Ukrainian Parliament. The son set up the Farm without any formal link to the father's farm but under his advice and close supervision. The father of the Farm Owner characterized his professional relationship with his son in the following way:

We have to balance our interests but only on an economic basis. Although my co-owners know that I regularly visit my son's fields I do not make any preferences to him otherwise I lose trust [Father of the Farm Owner, interview on 10 September 2007]

Business contacts with the father's farm were rare. Where transactions were initiated, they occasionally had a better than average terms of contracts for the son – cheaper prices for seeds and free rent of the machines. Yet the favours were reciprocated by the Farm by tolerating the payment delays of the father's farm or offering favourable contract terms to them. Moreover, at least in one case, the father's personal connections turned out to harm the son rather than help him (Case No 2.5 Mariupol Farm, Appendix 3).

In a similar vein, the relationships with the Farm's sister-companies, co-owned by the Owner and his classmates, were not particularly exceptional. Once in a while, they offered each other unusually long trade credits of up to six months. During the course of my study I identified only two such contracts.

Thus contractual relations with the friends and family members were limited and not exceptionally different from transactions with the other trading partners of the Farm. Instead, sister-companies of the Farm frequently used each other for tax evasion purposes. The Farm annually signed some fifteen so-called 'technical' contracts (making roughly one tenth of all contracts) with one of the two sister-companies for lending each other certain amounts of money. These contracts were explained to be pure fiction to serve, in the words of interviewees – the purpose of 'tax optimization' (i.e. tax evasion). Yet they showed that personal relations entailed the highest degree of mutual trust that could backup businesses in risky matters unrelated to contract enforcement.

Personal Relations Originating in Repeated Dealings

With the exception of the Sales Department of the Plant, where personal relations with the state-owned clients were encouraged as a business strategy (discussed in the following section), all other interviewees in this study characterized their relations with contracting partners as amicable (*priyatel'skiy, tovarishcheskiy*) and partner (*partnerskiy*) as opposed to friendly (*druzheskiy*).

In amicable relationships trading partners were neither friends nor strangers. As explained by the interviewees:

We have only working contacts but when the sales managers come we can joke and talk about something else. Also when I occasionally meet them on streets I do not pass by, we greet each other and say a few words [Salesman B, the Café, interview on 2 November 2009]

Furthermore, in partner relations the trading partner is trusted primarily for its business and professional qualities:

I trust Ivanov, not his company. But I trust Ivanov not because he is a good guy, but because he works well, he is a good specialist and a decent (*porjadochnyy*) partner [Owner of the Small Innovation Firm, the Plant's Supplier, interview on 13 October 2011]

Some interviewees in this study were quite conscious that their relations with the trading partners should not transgress the border of friendship or '*svoi*' (ours). All of the interviewees expressed their reservations against an overly personal style of communication. As they put it:

Yes, we have personal contacts but they do not influence the business. If my acquaintances ask me about something in business – we talk and apply to them our basic conditions of sales, if they do not want then we do not work with them [Director General, the Plant, interview on 6 September 2007]

I do not like personal relationships in business. Business ends when friendship begins. I differentiate only between the new and the permanent

suppliers [Head of the Supply Department, the Plant, interview on 28 October 2008]

With the years the relations get stronger but still do not cross the border of friendly relations [Farm Manager, interview on 28 December 2009]

In business, personal contacts are not in the first place. If you let me down once and twice, what is the use of my personal contacts with you? [Café Owner, interview on 18 October 2008]

On a few occasions the interviewees referred to the Russian proverb to exemplify their attitudes to personal relations in business: ‘friendship is friendship but business is business’; and ‘friendship is friendship but tobacco [in another variant – ‘meatpies’ (*pirozhki*)] is another thing’. This saying stressed the calculative nature of relations between Ukrainian businesses and thus its amicable nature.

To give more insights into relations with the regular trading partners that originated in repeated dealings, I examined three types of interconnected social activities as indicators of intimate personalized relationships in Ukrainian cultural context – alcohol drinking, greetings with various occasions, and informal meetings. Within the networks of the researched companies each of them proved to be generally diminishing and being replaced by other more formal practices.

From vodka drinking to cognac gifts

As Mary Douglas points out, ‘drinking is essentially a social act, performed in a recognised social context’ (Douglas 1987, p. 4). In the Ukrainian cultural context, the joint consuming of food accompanied by alcohol is considered as a ritual to confirm one’s belonging to a closed circle of our people (*svoi*) – those who belong to the same community and share the same beliefs (Tymczuk 2006, p. 63). This symbolic role of alcohol was confirmed by the interviewees in this study. According to the Farm Owner:

When you drink vodka, relationship becomes better, more honest. The border between formal and informal is transgressed. So, it becomes '*po ponyatiam*' [based on informal rules] [Farm Owner, interview on 17 October 2008]

Joint vodka drinking with the trading partners was not reported to be spread in contemporary Ukrainian business. Most interviewees consciously refrained from this practice. When prompted directly a few examples were revealed.

The Farm's supplier who gave me an interview told that he used to take suitcases of money and go to the Russian machine-building factory to 'water the whole factory'. However, by the end of the century this practice, if it ever existed in business, was reported to be virtually gone.

The Café Owner had ever drunk vodka only with the sales manager of one supplier – the beer supplying company Agroservice. This relationship started up as successful business cooperation in the turbulent 1990s. Later it turned into personal sympathy when the trading partners spent free time during weekends with their families in the Owner's Café. However, the friendly element of the relationship eventually shrunk and drinking stopped after the sales manager had been promoted to the director of the company.

Thus, as it was concluded by one of the interviewees:

Now in Ukrainian business only those drink vodka who worked in Soviet times [Owner of the Small Innovation Firm, the Plant's Supplier, interview on 13 October 2011]

Instead, alcohol was retained as a gift that manifested a more distant and less informal relationship than actual consuming of alcohol. For example, the Farm Manager annually visited four or five most important buyers on occasions such as the New Year or the Day of Farmer. He brought them plastic bags with bottles of expensive cognac and boxes of chocolates. This perhaps helped to slightly smooth contractual relations with these

companies but did not substantially influence contract enforcement with them. As explained by the Farm Owner:

The large companies have a complex structures and coordination. The Farm Manager brings presents to managers or the Heads of the supplies departments in order that they 'close their eyes' for some minor things – a minor deficiency in formal documents or minor quality problems of grain, and accelerate our transactions. And often they do close their eyes. They say: 'this time we forgive you, but next time do it properly' [Farm Owner, interview on 25 December 2010]

As a rule, both drinking alcohol and bringing alcohol as a gift in the Ukrainian cultural context was connected to special occasions (Tymczuk 2006, p. 65). Officially established professional holidays such as the Day of Lawyer, the Day of Judges, the Day of Metal Worker, the Day of Farmer etc., were occasions when businesses in these spheres were celebrated and gifts deemed appropriate. The New Year, the Women's Day (the 8th of March) and the birthdays also prompted gift exchanges.

Thus joint alcohol drinking as a ritual tying both contracting partners into a close business relationship has almost vanished from the practices of the researched companies. In a limited number of relationships, it has been replaced by the gifts of alcohol for specific occasions. Yet even this practice was reported to have a minor influence upon the contract enforcement of the parties.

From sauna meetings to mobile telephones

The use of informal meetings was reported to have diminished tremendously within the last decade. With a few exceptions the contacts of the researched companies with their trading partners were limited only to the matters of business and mostly through telephone connections.

Although the Café regularly saw the trade agents of all the suppliers who delivered goods on site she has not met most of their supervisors but talked over the phone to them.

The interviewees at the Plant and the Farm also reported quite a few trading partners whom they have never ever met in person or met once long time ago. As they explained:

I only talk by phone to most suppliers, write letters and do not see them because they are located in other regions. Sometimes I meet them on exhibitions or in business trips [Head of the Supply Department, the Plant, interview on 7 November 2008]

I have never seen the client from Western Ukraine [Ilnitskiy Plant] but we talk regularly over phone. Their Director promised to come to see us but never did, [Sales Manager C, the Plant, interview on 3 September 2007]

We can work with partners through fax and telephone but never meet. For example, that is how we work with Pologovskiy Oil Refinery. Long time ago their Director came and took samples of our grain. That time something has not worked out but I keep calling them regularly to enquire their prices. They joke – ‘Aha, this is Konstantin who asks about the prices but never sells us anything’. This year I told them – ‘This is momentous year when we finally begin to work with you’. So, we had a deal with them and it went smoothly. But we still have only faxed copies of the contract from them [Farm Manager, interview on 15 December 2010]

Although we have met all buyers and almost all suppliers, we still can contract without seeing the key managers of the partner. For example, I have not met our new supplier of chemistry Azovkontrakt but have paid UAH 400,000 without seeing them [Farm Owner, interview on 26 December 2011]

Thus by the end of the first decade of the new millennium telephone communication occupied a predominant place in linking the trading partners. All managers had the mobile telephone numbers of their counterparts from the other companies and used them extensively. The interviewees reported that, in principle, they could call their trading partners of the same rank ‘any time of the day and night’ including the weekends but only if they really needed it.

Having tremendously eased communication between the trading partners, telephones had the opposite effect of preventing access in the case of problematic relationships. The most widely used tactic of defaulting parties was reported to cut off

telephone communication or according to the interviewees to ‘freeze themselves’ (*otmorozit’sya*). That meant not to answer telephone calls, neither mobile nor landline. In the latter case the secretaries got involved in the game and made whatever excuses they could in order not to connect to their bosses. Eventually, personal visits to the defaulters’ offices signified the seriousness of the intentions of the trading partner and a further escalation of the confrontation.

Thus telephone communication had largely replaced the personal meetings of the trading partners in the business relationships of the researched companies.

To conclude the section on the role of personal relations in the contract enforcement of the researched companies, contrary to the popular assumption and some previous research on business in transition economies, this study found no evidence that friends and family links had a direct effect on contractual compliance in Ukrainian business any more. Relationships between regular trading partners relied upon alcohol gifts instead of joint vodka drinking, and mobile telephone communication instead of sauna meetings. They were based strictly on reciprocal motives and stopped short of an altruistic sacrifice of any amount of profit in favour of trading partner. Therefore personal relations affected contractual compliance largely indirectly – by enhancing bilateral trust between the trading partners. Thus contemporary business networks in Ukraine are not generally constrained by ethnical, religious or kinship links, but are built largely around for-profit considerations which allow for new entrants and certain degree of flexibility.

6.3 State Involvement in Private Contract Enforcement

All the contract enforcement mechanisms analyzed in Chapter 5 and the previous sections of this chapter were explored in the context of the typical contractual relationships of the researched companies. Yet this study has also identified an exception – business relationships involving the state in various capacities. State involvement became evident only in two of the Farm’s relationships, the same number at the Café, and up to 10% of the Plant’s relationships. Despite being exceptional, these relationships were reported to entail serious consequences for the researched companies.

State involvement in private contract enforcement took two forms – (i) relationships with the state-owned enterprises, and (ii) relationships with the state agencies and quasi-state private companies. The former relied upon kickbacks from suppliers (*otkat*) and the latter upon administrative resources, although both could be used in both types of relationships involving the state.

6.3.1 Contracting with the State-Owned Enterprises

Notwithstanding massive privatization, around 20% of Ukrainian companies currently retain at least one quarter of their shares in state ownership. State-owned enterprises, namely coalmines, were frequent trading partners of the Plant (Case No 1.3 DUEK, Case No 1.7 Rovenki, Appendix 3). These coalmines as many other state-owned enterprises in Ukraine exhibited notable specific features.

First, they were permanently underfinanced by the state budgets. Consequently, they were not able to prepay their contracts and chronically delayed payments to suppliers.

Second, the stability of business relationships with the state-owned enterprises was undermined by frequent change of their management. It was not a secret that the directors

of the Ukrainian state-owned coalmines were rotated every year or even every half a year. The interviewees at the Plant confirmed the usual practice for a new director to sign a number of contracts with the private companies, receive the goods or services under the contracts and when his office comes to an end, leave contracts unpaid. Although legally the coalmine remained the same entity, a new director did not feel obliged to pay the debts of his predecessor because ‘it wasn’t his contract’. As explained by the interviewees:

At most of the state coalmines, directors are changed very often, almost every six months. When a new director comes he does not pay under the old director’s contract. Why? Directors come to steal, therefore they decide everything by themselves, they also often change the team [Sales Manager D, the Plant, interview on 12 November 2008]

Since directors [of the state coalmines] often change, they use the time to steal. They sign a lot of different contracts with *otkat*. Often they buy unnecessary things or things of very low quality. Of course when a new director comes he does not want to pay for that rubbish [Head of the Legal Department, the Plant, interview on 3 August 2007]

The third deficiency of relationships with state-owned enterprises concerned the impossibility to enforce contracts with them through the courts. Although private companies were free to sue the state-owned counterparties in commercial courts, they were not able to obtain their compensations pursuant to the judgment. Two laws promulgated by the Parliament in 2001 and 2005,⁴⁵ confirmed by the decision of the Ukrainian Constitutional Court, banned the mandatory disposal of assets of the state-owned enterprises whether inside or outside of bankruptcy proceedings. This left the private companies without meaningful recourse against opportunistic actions of the state-owned enterprises (Gianella and Tompson 2007, p. 21, Usheva 2007).

⁴⁵ The Law of Ukraine No 2864-III ‘On Moratorium of Forced Seizure of Assets’ of 29 November 2001 <http://zakon.rada.gov.ua>; The Law of Ukraine No 2711-IV ‘On Measures to Ensure Continuous Operation of the Fuel and Energy Sectors’ of 23 June 2005 <http://zakon.rada.gov.ua>

Yet these substantial deficiencies of contracting with the state-owned enterprises were outweighed by lucrative business opportunities. Owing to the access to the state financing and unlimited rent-seeking opportunities, the state-owned enterprises could offer exclusive trade to their private trading partners and extremely profitable deals.

For example, interviewees active on the cable market reported that a few state-owned coalmines unofficially established satellite suppliers owned by their relatives or the state officials, and were served exclusively by these firms. According to the Plant's supplier:

There are small firms that serve only one state-owned enterprise, the access to which was bought by administrative resources. For example, I heard that coalmine X is served by the cable trading company registered by the nephew of one MP. They do not let any others in and share the profits [Manager of the Cable Trading Company, the Plant's Buyer, interview on 19 October 2011]

Moreover, the state-owned enterprises were able to offer prices which were substantially higher than market prices. For example, the prices for coalmining cables sold by the Plant to the state-owned coalmines exceeded production costs by ten times.

Thus despite the deficiencies in the enforcement of contracts with state-owned enterprises, many private businesses voluntarily and eagerly colluded with them to collectively extract rents from the state, ultimately at the expense of general population. This logic was explained by one of the Café's supplier by the following example:

We are perfectly aware that the state badly finances school canteens but we nevertheless work with them. I deliver them the goods and they pay when they can. But in return they take the goods that I need to get rid of [apparently outdated and unpopular goods] [Sales Manager of the Food Trading Company, the Café's Supplier, interview on 28 October 2011]

Given the problems of contract enforcement endemic to the relationships with the state-owned enterprises, in order to ensure contractual compliance private companies had to rely on kickbacks from suppliers (*otkat*) and personal relations.

Kickbacks from Suppliers (Otkat) and Personal Relations as Contract Enforcement Mechanisms

An illegal practice of cash side-payments known as kickbacks from suppliers (*otkat*) could arguably play a role in contract enforcement as an incentive to perform the contract. Although in developed economies kickbacks are mostly offered by suppliers, in the context of the post-Soviet transition buyers also frequently pay *otkat* to their suppliers. *Otkat* is calculated as a percentage of the sale and is paid by goods or services, in cash or into the bank account of the person in charge of transaction – either the chief executive or the manager.

Although the problems of internal fraud, management corruption and other kinds of white collar crimes arise from time to time in developed economies, these practices are particularly pervasive in transitional businesses. Chinese and Russian markets are frequently cited as suffering from nearly universal employee fraud and kickbacks from suppliers. According to Rozhnov, the losses of the Russian government from corruption in the public procurement system amounted to 10% of the state budget's income for 2010 (Rozhnov 2010). A workplace environment governed by the principle 'What you are not stealing from your employer, you are stealing from your family' was considered a fruitful ground for internal fraud and management corruption (Babinov 2011).

Admittedly, *otkat* was a widely spread phenomenon in Ukrainian business. Up to 15% of private companies and nearly all state-owned enterprises were reported by the interviewees to be involved into this practice. Where *otkat* was involved, it played the role of tax evasion device,⁴⁶ as a device to convert money from bank accounts into cash banknotes, as an anti-competitive device in entering new markets, or as a means of personal enrichment at expense of the employers. Compared to these functions of *otkat*, its capability to ensure proper contract performance was a by-product of corrupt activity rather than its immediate goal.

In a typical business relationship among private companies, one did not need to pay *otkat* to receive contractual payments or goods in time. Repeated dealings paired with self-enforcing mechanisms were perfectly able to secure contractual compliance in most of these cases.⁴⁷ These were relations with the state-owned enterprises where *otkat* came out as a powerful contract enforcement device. The contract enforcement function of *otkat* invariably accompanied all *otkat*-based relations (*otkatnyye otnosheniya*) with state-owned enterprises through the personal material interest of the employee in charge of the transaction to ensure its smooth flow.

The law on state procurement required that the state-owned enterprises organized tenders for large supplies. These tenders were reported to almost inevitably involve supplier's kickbacks or other illegal payments. Senior management of the private companies interested in contracting with the state enterprises was aware of the need to pay *otkat*; they supplied their managers with cash or authorized transfers to the private accounts and generally supervised these shadow transactions.

⁴⁶ The higher was the official price of the goods, including unofficial cash *otkat*, the more VAT could be returned from the state budget.

⁴⁷ There were a few indications that *otkat* between private enterprises could also serve limited contract enforcement purposes, namely when the debtor was close to bankruptcy. However, even in the aftermath of the 2008 crisis, bankruptcies of private companies remained exceptional in Ukrainian business.

While *otkat* among the private companies was viewed by their owners as an extremely detrimental practice and entailed certain investments in its combating,⁴⁸ *otkat* in business relationships with the state-owned enterprises was openly practiced and was treated as an accepted, almost legitimate, practice. The Farm Owner shared his experience of dealings with *otkat* at the state-owned enterprises:

I think directors know and sponsor *otkat* at the large plants to pay for tenders with the state enterprises. So, it is more or less 'legitimate' (*zakonnyy*). There are some state enterprises where everyone knows about *otkat*. For example, we worked with the state company X and their Director took *otkat* from one kind of transactions, and the chief engineer – from another. All was divided [Farm Owner, interview on 23 December 2011]

As was evident from the interview cited above, the scheme of shared *otkat* involved the separation of transactions (who takes *otkat* from what type of transactions). In another reported sharing scheme, an employee of the lower rank who initially received the *otkat* payment transferred a certain percentage of it to their manager and the latter – to the senior manager. The profits from *otkat* in this case were shared among all the employees involved in the transaction, up to the chief executive officer.

The preservation of organizational routines from the Soviet planned economy at the state-owned enterprises and reliance upon *otkat* in enforcing contracts with them inevitably enhanced the importance of personal ties in these relations. Personal relations were directly linked to *otkat*; as it was put by several interviewees: 'personal relations in this business mean *otkat*'.

The difference between personal relations with state-owned and private companies was highlighted in respect to two sales managers of the Plant, one in charge of contracts

⁴⁸ To prevent *otkat* from being paid by suppliers to the Plant's purchase managers, the Economic Security Department of the Plant employed a person whose primary responsibility was to monitor prices and terms of delivery of inputs at the local market. She approved the contracts submitted by the purchase managers only if they incorporated the best market prices available at the moment. Contracting at the lowest possible prices eliminated or at least sufficiently decreased the likelihood of *otkat*.

with the state-owned coalmines, and the other with the large modern private companies mostly held by oligarchs.

When I met him, the ‘state’ sales manager was an elderly person in his early fifties with a round belly and cunning eyes. His style of work with the clients was based on the personal type of relationships characteristic of the Soviet management. He described his style in the following words:

Everyone has his own style of work. I can tell a client to fuck off and in a week time we can drink vodka again, wake up in the same room or go to the sauna. I try to intermingle business ethics with friendly relations and always stay personal [Sales Manager B, the Plant, interview on 3 September 2007]

The ‘private sector’ sales manager was in contrast a younger slim and sporty person in his thirties. He explained that he mostly dealt with the large private companies which worked under western corporate standards. Therefore his style of work relied upon written correspondence with the clients.

Apparently, the head of Human Resources of the Plant had sensibly distinguished the personal traits of these managers and charged them with different groups of clients – state-owned and private companies. The difference in styles of work was so noticeable that the lawyers referred to one as the ‘dark past’ and to another as the ‘bright future’ of the Plant:

B and C are two sales managers with the opposite styles of work. B is remaining of the dark past, C is our bright future. B has to drink vodka with the middle level managers. C has creative mind, he works based on documents and corporate culture. These two people have different psychologies [Head of the Legal Department, the Plant, interview on 6 September 2007]

Thus a personalized type of communication and personal links retained a greater significance in the business relationships involving state-owned enterprises.

To conclude, business relationships with state-owned enterprises were prone to many deficiencies. To overcome their negative impact upon the contractual discipline of the state-owned enterprises, private businesses had to resort to kickbacks from suppliers and enhanced personal relations as powerful contract-enforcement mechanisms.

6.3.2 Contracting with the State Agencies and ‘Muddy’ Companies

As demonstrated by Chapter 3, the wider environment of Ukrainian business was characterized by the possibility of state officials and private companies resorting to bureaucratic hierarchies and the material resources of public institutions to advance their private gains – the so-called administrative resources.

Administrative resources have been studied by post-Soviet researchers in spheres as diverse as electoral politics, judiciary and business, and have been demonstrated to operate through coercive measures such as instigated inspections of businesses by state organs (Vinogradova 2005), criminal prosecution (Gans-Morse 2011), and withdrawal of access to public goods (Allina-Pisano 2010, p. 374).

The use of administrative resources in contract enforcement among businesses in Russia was highlighted by two studies (Hendley *et al.* 2000, Vinogradova 2005). Both discovered the strategy of turning to state officials for help in solving problems with customers and suppliers, but documented its decline in contemporary Russia. Hendley and colleagues referred to this transactional strategy of the Russian businesses as ‘administrative levers of the state’ (Hendley *et al.* 2000, p. 642-643) and Vinogradova – as ‘the threat of punitive actions by state officials’ (Vinogradova 2005, p. 145-150). According to Vinogradova:

Firms that use, or used, the threat of punitive actions by state officials as a contract enforcement strategy capitalize on different kinds of connections

with different results. They can bribe low level officials from state regulatory organisations to conduct unscheduled check-ups and then bury the offender in fees and fines; or they can use high-level state officials to threaten the offender in various ways (Vinogradova 2005, p. 149)

This study has also identified the use of administrative resources in private relations between Ukrainian businesses albeit with a different twist.

It is an acknowledged fact that many, if not most, companies in Ukrainian business retain some links to state officials of various ranks. For example, the Café Owner was connected to the former KGB officer through her husband's family, and the Farm Owner was himself elected as a deputy from the governing Party of Regions to the local district council. However, these links were claimed by the interviewees not invoked by them in business-to-business relations.

Instead, all the three researched companies have themselves suffered from manipulations by some of their trading partners – people who can abuse the machinery of the state. The section below explores how administrative resources were employed in these relationships as a contract enforcement mechanism and exerted a direct impact on other contract enforcement mechanisms.

Administrative Resources as a Contract Enforcement Mechanism

Administrative resources played a role of an important contract enforcement mechanism in the relations of the researched companies with state agencies when they were acting in a commercial capacity. Furthermore, the interviewees reported that a few private companies in their trade availed themselves of administrative resources when dealing with their trading partners. These private companies were referred to as 'muddy' (*mutny*). Both state agencies and 'muddy' private companies possessing access to administrative resources are referred to in this study as administrative resource holders.

First, this study reveals that the threat of administrative resources was invoked to pressurize private companies to transact with administrative resource holders and consequently to accept unfavourable contractual terms from them.

Although the Café Owner was not directly forced into contracting with the state-owned Leisure Park and the City Council, she had no other choices in her specific circumstances but to lease her trade spaces from them.

The Farm was on a few occasions actually forced into contracting with the quasi-state grain traders within the program of the governmental procurement of grain for the state reserve fund. It was asked by the officials of the local state administration to sell its grain to the specified company – Hlebinvestbud. Although this trader was *de jure* a private company, the state retained some shares, the precise amount of which was never revealed to the public. Furthermore, this small private company for unknown reasons received noticeably preferential treatment from the government (Stack 2011). When selling grain to Hlebinvestbud, the farmers were also told to bring their grain to a specified storage (Case No 2.2 Elevator Rodnik, Appendix 3). When private farmers did not rush to sell their grains to Hlebinvestbud they got a few telephone calls. As revealed by the Farm Owner:

Everyone has got the telephone call from the local State Administration: ‘You know, we are also dependent people (*lyudi podnevol’nyye*); sell X amount of grain to Hlebinvestbud.’ And if I say ‘no’? You can’t say ‘no’ [Farm Owner, interview on 7 September 2011]

Eventually, according to the Farm Owner, the farmers did what they were asked to do.

The second use of administrative resources in contractual relations identified by this study was to pressurize private businesses to terminate business relations with certain trading partners and thereby to restrict competition at the market. The Plant was asked to

terminate its contracts with the certain suppliers of copper – private companies which lacked an unofficial ‘roof’ (*krysha*) – that is, ties with the current government. The so-called ‘cleansings of the market’ reported in 2010 relied upon raids of the tax inspectorate to invalidate supply contracts with the unwanted suppliers. As the result, the Plant terminated its business relationships with five suppliers of copper.

The third use of administrative resources in business relations identified by this study was to pressurize the businesses to tolerate the contractual faults of the administrative resource holders and to silence claims against them. It was implicit that the claims for deficient contract performance of the latter were inadmissible. For example, when the Farm had to sell grain for the state reserve and to store it at the assigned grain elevator, this elevator unilaterally downgraded the quality of the Farm’s grain. Yet the Farm Owner deemed it pointless to involve an external laboratory to prove its rights. It was easier to be silent about the matter and never come back to this elevator unless pressurized again by the administrative resources (Case No 2.2 Elevator Rodnik, Appendix 3).

If the threat of administrative resources did not induce private businesses to obey, this was activated through instigated inspections by various state organs and imposition of fines of ‘stubborn’ private businesses.

Unfortunately, the Café Owner experienced this power twice. In the Leisure Park Case (No 3.4, Appendix 3) the Director of the state-owned Leisure Park, who attempted to evict the Café Owner of her premises in the Park, initiated intimidating inspections of the Café by the tax, fire, sanitation and occupational safety inspectorates, and Prosecutor Office, all of which imposed outrageous and arbitrary fines at the Café. Ultimately, the Prosecutor Office filed a lawsuit with commercial court against the Café Owner and initiated a fabricated criminal prosecution against her.

By the same token, administrative resources were employed by the City Council in attempt to terminate the lease contract for the Owner's kiosk in another case (Case No 3.3 Kiosk, Appendix 3). Although the law was completely unclear on the point as to whether the small businesses operating street kiosks required land permits, in 2010 the Café Owner was subjected to numerous inspections by the Prosecutor Office and the Department of Land Resources demanded such permits. Eventually, while the neighboring kiosks were forced to leave, the Café Owner's kiosk remained in place because she 'has solved everything at the upper level of Regional Land Commission' [which apparently meant bribing higher state officials].

To conclude, private contract enforcement with those who hold the levers of the machinery of the state – state agencies and some 'muddy' quasi-state companies – was characterized by the resort to administrative resources through unofficial ties to local government in order to pressurize private businesses to deal with them and to accept less than favourable contract terms; to tolerate their contractual defaults; to attack the property rights of private businesses and to suppress their disobedience through the instigated inspections of the state organs and the imposition of fines. Although these were highly distinct and disruptive contractual relations, they were still an exception which should not overshadow the more widespread practices explored in the previous sections.

6.4 Conclusions

The findings of this research reveal that a contractual pattern identified in most relationships of the researched companies comprises various combinations of repeated dealings and self-enforcement supported by reputational mechanisms, and indirectly by personal relations.

In contractual relations between private businesses, the contract enforcement capacity of reputational mechanisms and personal networks was found to be quite insignificant. It was only the reputational mechanism of brand names which was capable of replacing the main self-enforcing devices, others operated in concert with repeated dealings and self-enforcing devices, discussed in Chapter 5.

The brand name reputational mechanism in Ukrainian business became evident in relations with a few powerful international and Ukrainian corporations, including those owned by Ukrainian oligarchs. They were considered to have established their reputations of high quality providers and timely payers. Owing to their powerful market positions, they required no reliability screening and researched companies were prepared to offer them trade credits at the first transaction. Thus branding as a reputational mechanism was capable of replacing prepayment even in discrete contracting, yet with respect to a few brand name holders.

Other reputational mechanisms were found by this study to still remain in their infancy or to be of lower significance. Gossip was the main channel of reputational information dissemination within the networks of the researched companies which relied upon occasional informal communication between individual companies, the turnover of managerial personnel, informal gatherings at seminars and social events, and communication with local state officials.

Gossip networks of the researched companies displayed a few notable deficiencies. Businesses interviewed in this study were reluctant to spread *on purpose negative* reputational information about overdue payments of their contracting partners even within their immediate business network. Information on the unsatisfactory quality of goods or services was shared more readily, albeit also restrictively. Thus, by the end of the first

decade of the new millennium, owing to the limited number of players in the local markets, information on them was generally known to the researched companies through uncoordinated gossip.

Under these conditions, the screening of prospective trading partners through enquiries from colleagues or Internet research did not increase their trustworthiness. Therefore, in contrast to the documented reliance of business in developing and transition markets on reputational screening, this study reveals its general decline within the networks of the researched Ukrainian companies. It was largely confined to enquiries about the quality of products and services of first-time suppliers.

This decline turned out to be logical when examined in the light of other contract enforcement mechanisms used in contemporary Ukrainian business. As explained above, the reputation of the few brand name holders did not require any additional screening as they were at least tentatively known to everyone. Screening of the remaining first-time trading partners was replaced by prepayment, quality self-enforcing devices, trading with small amounts, and in exceptional cases by kickbacks from suppliers.

Given the deficiencies of uncoordinated gossip and screening mechanisms in the dissemination of reputational information, reputational sanctions in the networks of the researched companies were confined to the denial of bilateral trade or trading under grossly unfavourable conditions such as full prepayment.

Additionally, this study has not documented a single fully-operational multilateral reputational mechanism within the business networks of the researched companies. Neither did a strong demand for such mechanisms become evident in this study. Informal gatherings of the local cable producers at the seminars and an unofficial system of matching agricultural suppliers with farmers by the local state agencies resembled trade

associations only distantly. In reality they were based on personal connections and individualized bilateral trust which enhanced gossip, but not on formal organizational structures. In an environment dominated by weak competition, repeated dealings and prepayment devices, the researched companies deemed collective reputational mechanisms irrelevant.

After having explored reputational mechanisms, this study examined personal relations as a contract enforcement mechanism. Personal relations originating outside the business – in family and friendship networks – were demonstrated to play a minimal role in ensuring contractual compliance. This is not to say that contracting was maintained on a purely impersonal basis; the personalized nature of business interactions which originated in repeated dealings was retained in Ukrainian business. However, personal relations between regular trading partners stopped short of the sauna sessions, joint alcohol drinking and frequent face-to-face meetings which were depicted as typical mainstream mechanisms by early transition research. Instead, they moved to ‘partner’ and ‘amicable’ interactions with mobile telephone communication and occasional alcohol gifts as a symbolic manifestation of the relationship.

Apart from the mechanisms supporting the enforcement of contracts in the typical business-to-business relationships of the researched companies, it was impossible to overlook the exceptional operation of contract enforcement mechanisms in relationships involving the state. Although it was relevant only for a few relationships of the researched companies (two at the Farm and the Café, and up to 10% of sales contracts of the Plant), it was clearly more troublesome for the researched companies.

While this exceptional pattern still relied upon repeated dealing and self-enforcing devices analyzed in Chapter 5, supporting contract enforcement mechanisms were quite different: kickbacks from suppliers and administrative resources.

Kickbacks from suppliers (*otkat*) dominated the business relationships of the researched companies, namely the Plant, with the state-owned enterprises. *Otkat* with the state-owned enterprises was reported to be nearly universally and almost openly practiced in Ukrainian business. In relationships with the state-owned enterprises handicapped by under-financing from the state budget, the frequent change of upper management, and the impossibility of contract enforcement through the courts, the personal material interest of the directors in kickbacks from suppliers (*otkat*) became a powerful contract enforcement mechanism to induce state-owned enterprises to honour their contractual obligations.

In most cases, attracted by lucrative business opportunities at the expense of the state budget, the upper management of the private companies initiated *otkat* themselves or sponsored it through operational level managers. The directors of the state-owned enterprises personally benefited from *otkat*, although various schemes of sharing profits from *otkat* between employees and directors were in place.

The largely untouched Soviet organizational routine at the state-owned enterprises and the prevalence of *otkat* in their contractual relations with private businesses, conditioned the enhanced role of private relations. State-owned enterprises imposed a personalized style of ‘vodka-drinking’ and face-to-face communications on the private trading partners reminiscent of the Soviet epoch.

Contractual relations involving state agencies acting in a commercial capacity and some private companies – those with access to use the machinery of the state – was characterized by a reliance upon administrative resources. Administrative resources in

these relationships were used through the threat of, or through actual use of, financial and non-financial inspections by the state agencies resulting in the imposition of fines upon private businesses.

The threat of administrative resources pressed the researched companies to initiate transactions with those who used it, to accept less than favourable contract terms offered by them, to tolerate their contractual defaults, and to terminate business relations with other private businesses. Where this threat did not induce the desired behaviour of the private contractual parties, the machinery of the state was actually activated to attack the property rights of private businesses.

CHAPTER 7 PUBLIC CONTRACT ENFORCEMENT MECHANISMS

Chapters 5 and 6 explored the operation of private mechanisms that ensured the high effectiveness of contract enforcement system in Ukrainian business with less than 1% of transactions requiring legal assistance. Yet the role of law and courts is not insignificant and is discussed in this chapter.

When private contract enforcement mechanisms become inoperable, dispute resolution in the context of Ukrainian commercial relations may take two distinct, not always consecutive, but interconnected paths. First, the parties to a dispute could exchange formal pre-trial claims called *pretenziya* and threaten to apply to the courts. Second, if further escalation of the dispute is inevitable, the claimant could cross the courts steps by filing a claim (*isk*) in a commercial court. The following sections of this chapter address *pretenziya* and courts separately and in their interrelations.

7.1 Pre-trial Claims – *Pretenziya*

The inquiry into the use of *pretenziya* by the researched companies relies upon an examination of the letters of *pretenziya* and reflections on *pretenziya* and the underlying business relationship by the interviewees. As illustrated by Table 7.1, I was able to analyze 92 *pretenziyas* written by and to the researched companies: one at the Café (2004-2011), four at the Farm (2004-2011), and the rest at the Plant (2007-2011).

Table 7.1 *Pretenziyas* and their Outcomes⁴⁹

Researched Companies		Initiated by the Researched Companies		Initiated against the Researched Companies	
			<i>Of which went to courts</i>		<i>Of which went to courts</i>
Café 2004-2011		1	1	0	0
Farm 2004-2011		4	2	0	0
Plant	2008	15	1	9	0
	2009	14	4	12	0
	2010	3	2	14	2
	2011	3	0	17	5
	<i>Subtotal</i>	35	7	52	7
TOTAL		40	10	52	7

7.1.1 The Nature and Legal Framework for *Pretenziya*

Most studies of business and courts in the post-Soviet transition have omitted the institution of *pretenziya* (Halverson 1996, Hendrix 1997, Frye 2002), with the remarkable exception of Hendley and colleagues (Hendley *et al.* 2000, Hendley 2001). In their study of contractual relations between Russian industrial enterprises, they have analyzed *pretenziya* along with contractual penalties and collateral arrangements under the rubric of ‘shadow of the law’ strategies (Hendley *et al.* 2000, p. 643). *Pretenziya* was seen as constituting the threat of litigation; debtors were willing to pay at this ‘juncture’ because ‘by paying before the case was filed, the customer could escape paying the filing fees and will often be excused from penalties and interest’ (Hendley 2001, p. 26).

The findings of this research suggest that *pretenziya* would be better understood if analyzed separately from the court system. In many instances *pretenziya* proceedings proved unconnected to the courts or to the threat of court action; its functions were quite

⁴⁹ Source: Data drawn from author’s fieldwork.

different from those deployed by the courts. Law and lawyers played an even lesser role in *pretenziya* than in court proceedings.

Owing to its mixed nature, *pretenziya* presents a bridge between the private and public, business and legal realms. On the one hand, *pretenziya* is a solely private, bilateral mechanism, as no state or governmental agency is actually involved in its operation. *Pretenziya* is exchanged between two trading parties and concerns their commercial relations. On the other hand, *pretenziya* relies heavily on the threat of the resort to the public courts. It most notably transforms mere bilateral disagreements into legal disputes through legal discourse.

As *pretenziya* has its historical origin in the Soviet law and practice of the 1960s, this merits an examination of these roots. Under Soviet law all disputes between socialist enterprises were to be resolved by the parties themselves through the procedure of pre-trial dispute resolution (*pretenzionnyy poryadok*), normally without the intervention of a third party. Only when this did not work could they pursue the matter in court (at that time known as *arbitrazh*). Upon filing the claim in court, the claimant had to present evidence that the *pretenziya* had been rejected by the respondent.

After Ukraine became independent in 1991, this compulsory pre-trial procedure was questioned and eventually abolished in 2002 by a Decision of the Constitutional Court of Ukraine. Article 1333 of the Decision states:

Compulsory pre-trial dispute resolution that excludes the possibility of having the claim considered [by courts], and justice delivered based thereon, violates the human right to a fair trial ... The choice of a certain method of legal defence, including pre-trial dispute resolution, is a right but not the duty of a person.

This decision was followed by amendments to the Code of Commercial Procedure making the pre-trial claim procedure (*pretenziya*) voluntary except in cases involving

transportation, communication and state contracts (Code of Commercial Procedure, Article 5). Although voluntary in most cases, the Code nonetheless contains, in Part II, seven articles regulating *pretenziya* in minute detail: the form and content of the letter which should be sent to the party in breach; the time limit for considering the claim (generally one month); the content and form of the reply, etc.

Notwithstanding its voluntary nature, Ukrainian companies nowadays still widely use *pretenziya*. The 2007 IFC survey found that 73.2% of surveyed Ukrainian companies of all sizes had resorted to *pretenziya* in the latest dispute (IFC 2007). Its form and the legal discourse couching it remain largely unchanged from Soviet times. The templates circulated amongst Ukrainian businesses are almost identical. The text begins with a description of the initial phase of the current transaction – the contract signing. It proceeds to list the contract obligations which were allegedly violated by the debtor and gives the references to the Articles of the laws. It then demands that the debtor duly fulfils its obligations. Finally, it warns the debtor that should these demands be ignored after a certain time period (usually ten days or a week), the injured party will have to begin to assess penalties and resort to litigation.

Given this discourse, *pretenziya* is conventionally viewed as a last attempt to settle before going to court; the last warning which evidences the earnestness of the intention of the injured party (Hendley *et al.* 2000, Hendley 2001). Apart from this ‘legal’ function, the research presented here has also identified a number of socio-legal functions of *pretenziya* which go beyond the threat of litigation.

‘Creative’ extra-legal uses of *pretenziya* proved more effective than the threat of court action. Not a single case ended up in court when ‘creative’ *pretenziyas* were used. In contrast, where the threat of litigation was the primary or only aim of *pretenziya*, it had

only a slight impact on the outcome of the dispute. More than one third of such disputes proceeded to trial. Indeed, the interviewees in this study reported serious doubts about the capability of the threat of litigation in *pretenziya* on its own to induce debt payment.

7.1.2 Legal Functions of *Pretenziya*: the Threat of Court Action

The use of the threat of court action implicit in *pretenziya* has been evidenced by this study at all three companies researched, albeit most of the cases originate with the Plant. The interviewees in this study clearly linked it to the likelihood of court action. In turn, the latter depended on a host of objective and subjective factors, such as the urgency of the claimant's need for liquidity, the claimant's ability to pay filing fees, the straightforwardness of the case, the likelihood of a positive judgment, the claimant's taste for revenge etc., all of which call for separate research. The *pretenziya* initiators themselves were often uncertain at that point whether or not they would actually sue the defaulter. Yet an analysis of the intentions of the claimants in actual cases of *pretenziya* illuminated that at least some likelihood of litigation existed when the amounts in dispute were substantial and the causes were beyond reasonable reach of remedy by the parties.

When the amounts in dispute were estimated, the size of the injured party was taken into account. The interviewees in this study considered amounts of more than UAH 10,000 (US\$ 1,000) for a small company, and around UAH 100,000 (US\$ 10,000) for a large enterprise, to suffice to warrant court intervention.

Additionally, court action was seen likely when the problems were caused by objective circumstances not entirely dependent upon the will of the parties, and therefore it was unfeasible to remedy this through private contract enforcement mechanisms.

Threat of Litigation in Disputes Caused by (Survival) Opportunism

Disputes rooted in opportunistic motives triggered by the debtor's financial desperation constituted the most numerous category of *pretenziya* involving non-trivial amounts. Opportunism, justified by the debtor's survival, technically remains to be opportunism – 'self-interest seeking with guile' (Williamson 1985, p. 47). However, the interviewees in this study clearly distinguished between survival-driven opportunism and, as Woolthuis et al. labeled it, active opportunism – lying, stealing and cheating to expropriate advantage from the contracting partner (Woolthuis *et al.* 2005, p. 813).

Active opportunism comprised schemes to 'dump the trading partner' (*kidal'nyye skhemy*). These were dealings originally designed with the sole purpose of deceiving the counterparty and 'hitting the jackpot'. Such schemes often involved multiple intermediaries and/or shell firms, but could also have less elaborate designs; for example, when a firm prepaid its purchases for the first few times, then disappeared with the first trade credit. In dumping schemes a mere breach of contractual promises was often interwoven with purely criminal elements like fraud or the forgery of documents.

The interviewees were able to recall only a handful of dumping schemes. Only one case involved the Plant as the victim of a dumping scheme (Case No 1.6 Lost Truck, Appendix 3). All others were based on anecdotal evidence or rumours dating back to the 1990s. Such deceptive dealings were unanimously reported to be happening less often in Ukrainian business, and at present were completely absent from the sample companies.

Being questioned about cheating and deceptive behaviour apparently caused some frustration to my interviewees. The demise of dumping schemes was something absolutely clear, logical and evident to all interviewees, including those at the Plant and the Farm. Yet

in small business it was most noticeable. The Café Owner's reaction is illustrative in this respect:

Now people work more honestly, because firms [in retail trade] are tied to their physical location. A businessman who built his shop with his own money and with his 'blood and sweat' would not risk it for a few thousand *hrivnyas*. Why would you soil yourself for mere thousands? Economically it's not profitable to cheat in small business [Café Owner, interview on 9 December 2010]

Thus active opportunism was claimed to be largely absent in the researched companies' relations with their trading partners. Instead, they suffered the consequences of opportunistic behaviour arising from debtors' genuine financial distress. A majority of these cases concerned payment delays, and a few delivery delays. When financial difficulties came into play, the validity of the debts was not disputed but performance was nevertheless delayed indefinitely – 'until we get the money'. If the debtor's financial situation deteriorated to the point of imminent bankruptcy, a quick resort to litigation was deemed practicable, and therefore *pretenziya* was used as the *ultimatum* of the earnestness of their intentions.

In the aftermath of the 2008 global financial crisis, the Plant itself presented a striking example of a debtor whose delays were mounting quickly in number and amount. There was no doubt that by 2009 the Plant already faced a liquidity crisis. The Plant's own in-house counsel estimates that in 2011 up to 80% of the Plant's payments under trade credit contracts were delayed. All the *pretenziyas* served against the Plant, therefore covered under its financial difficulties excuse, arose once the Plant also began delaying wages to its own employees for up to three months.

In a similar vein, interviewees reported that most opportunism in current Ukrainian business is caused by debtors' real financial desperation rather than the malice to exploit others.

To conclude, *pretenziya* served because of debtors' opportunism constituted the major part of all *pretenziya* registered at the three sample companies. The opportunism prompting these *pretenziya* was partly excused by the real financial distress of the debtors, which were all on the verge of bankruptcy, including the Plant itself. Given the non-trivial amounts of the claims, *pretenziya* in these cases was perceived by the interviewees in this study as a real threat of court action, but only up until bankruptcy proceedings were initiated by the defaulters. After that *pretenziya* did not make sense.

Threat of Litigation in Disputes Arising from Circumstances Beyond the Parties' Control

A few *pretenziya* with substantial amounts in dispute arose from circumstances beyond the parties' control – including two at the Plant and one at the Farm. In these cases, to threaten court action was the primary purpose of the *pretenziya*. Circumstances beyond the parties' control meant extraordinary changes in weather conditions, which caused an otherwise sound combine to work improperly, a substantial rise in petroleum prices caused by government decree, corporate raiding,⁵⁰ and a subsequent change of ownership of the trading partner.

The Farm's Newholland Combine Case offered an example in this respect. The Farm bought the expensive Newholland combine which eventually did not work properly. The technical problem causing the breakdown remained unsolved for a month. From the very first days the Farm Owner tried to pressurize the supplier to replace the combine by sending a *pretenziya* to it. However, this *pretenziya* was ignored and the whole matter never became a legal dispute until both parties agreed that global climate warming was to

⁵⁰ Corporate raiding or hostile enterprise takeover in the context of post-Soviet business is defined as 'a forced change of ownership and management practiced by influential business groups in relation to large (or medium-sized) enterprises' (Volkov 2004).

blame. After unsuccessful face-to-face settlement negotiations, a second letter of *pretenziya* was sent to the allegedly delinquent supplier. The fact that the cause of the problem was beyond the parties' control increased the likelihood of resorting to litigation in the perception of the Farm Owner and justified his use of *pretenziya*. When neither party was willing to recognize its own fault and pay damages, resort to the law became highly likely.

Thus where the amount in dispute warrants attention and fault may be excused as owing to circumstances beyond the parties' control, a subsequent lawsuit was deemed possible and *pretenziya* was meant to be a clear threat of court action. Indeed, two out of three *pretenziyas*, caused by circumstances beyond the parties' control, ended up in court.

7.1.3 Extra-legal Functions of *Pretenziya*

Extra-legal functions of *pretenziya* were documented only in the Plant's practice. The Plant possessed more organizational and legal resources than the Farm or the Café; most notably, the Plant had the luxury of two in-house lawyers working full-time at its premises comprising its Legal Department. Furthermore, owing to its own and many of its trading partners' complex organizational structures, which triggered numerous misunderstandings, the Plant had more chances to use *pretenziya* in a creative way than the Farm and the Café.

In disputes involving trivial amounts or in uncontested matters, litigation was dismissed by the interviewees at the Plant as completely unlikely, yet *pretenziya* were drafted and sent out to the delinquent customers anyway. This section explores the rationale behind these seemingly wasted efforts.

Pretenziya as Communication Tool

Pretenziya as a formal letter always functions as a communication and signaling tool. This function was most evident in business relations involving large industrial enterprises and trading companies with a complex internal organization.

In Ukrainian business, decision-making rests within upper management and sometimes is solely concentrated in the hands of the general director. The hierarchical nature of post-Soviet management dictates strict rules of etiquette whereby an employee of a certain status in one company must be approached by an employee of equal status of another company. Thus operational managers may speak only to other operational managers, lawyers to lawyers and directors to directors. Given this social environment, because the *pretenziya* letter is signed by the director (though usually drafted by lawyers) and addressed to the counterparty's director, it has a chance at least of being read. In addition to this advantage, *pretenziya* was seen by the interviewees in this study to be a helpful device for discovering the other side's legal position to take further counsel about the method of debt collection.

Thus *pretenziya* always plays a communicative role. However, as it became evident from the data, communication became the major and even the only function of *pretenziya* in cases of trivial debt – sometimes as little as UAH 100 (around US\$ 10). Such small amounts presented no threat to the well-being of any company and were often called 'the tails'. Nevertheless, they complicated accounting, drawing frequent complaints from the accountants, and therefore warranted some collection effort. The Plant also believed a policy of chasing up the smallest debt signalled its seriousness to its trading partners.

Many of the Plant's 'tails' originated in the practice of tolerance. A fact of cable manufacturing worldwide is that the cable can be cut off only at certain points. The

standard practice is to allow for some flexibility – in industrial terminology ‘tolerance’. Therefore cable as sold had an actual length between 0% and 5% of the length ordered. ‘Tolerance’ practice was well-known in Ukrainian cable manufacturing, and ‘tolerance’ clauses were clearly spelled out and agreed in the Plant’s written contracts. Nevertheless, some clients did not feel obligated to pay for unordered extra lengths.

Other cases when *pretenziya* was employed, notwithstanding the trivial character of the contractual problems, were termed ‘technical mistakes’ or ‘human factor problems’. Neither the three sample companies nor their counterparties were immune to mismanagement, bureaucratic problems and other failures; and *pretenziya* helped to overcome the consequences of these annoying problems. To give an example, the German company supplying new machinery to the Plant omitted to include one of the operating manuals with the machine. The lawyers had to draft a letter of *pretenziya* and translate it into German to let the German partner know about the omission.

Finally, *pretenziya* played a primarily communicative role in cases where litigation was warranted but ineffective because the judgments could not be enforced. According to current Ukrainian law, all Ukrainian enterprises where the state retained at least 25% of shares were shielded by the statutory ban of forced seizure of their assets (moratorium). All parties to disputes involving state-owned enterprises clearly realized that these debts were ‘dead’; therefore, *pretenziya* sent to state-owned companies was not aimed at pressurising the debtor to pay under threat of litigation. Instead, it operated mostly as a communication tool at the informal relational level. The Plant in two cases did finally sue the state-owned enterprises, with a slight hope that someday the moratorium might be repealed. It was also hoped that a judgment would at least make the Plant’s account books look better.

Thus, where litigation was out of the question (in the case of petty debts) or useless (in cases against state-owned enterprises), *pretenziya* played above all a communicative role.

Pretenziya as a Means of Neutral Mediation

Litigation was considered unlikely over ‘technical mistakes’ caused by both parties or when the mistake of one party triggered mistakes by the other. Observed examples of such shared failures included the following: the seller served a mistaken invoice and the buyer paid less than the contract price pursuant to the invoice; the buyer delayed the upfront payment and therefore the seller could not supply the required model of the machine; the seller erroneously supplied unordered extra goods and the buyer rejected their acceptance; the seller lost the documents and the carrier therefore did not supply the trucks in time.

When disputes arose from mutual mistakes and misunderstandings, emotional recriminations made a reasonable resolution at the operational level problematic. Lawyers in these cases played the role of informal mediators using *pretenziya* to discover the facts of the situation. Often what they discovered was that the Plant itself had been claiming debts erroneously, or that the Plant’s own failures had caused the debts. In consequence, the operational managers were able to settle between themselves.

Pretenziya for the Sake of Formalisation of Relationships

Quite a substantial number of *pretenziya* in the Plant’s relations with its suppliers were simply fake. Non-existent disagreements or those already settled were repackaged by the lawyers to look like legal disputes by the use of *pretenziya*.

The Plant’s lawyers in particular routinely drafted and dispatched *pretenziya* in uncontested matters without much deliberation. All information required to be included in

the *pretenziya* was supplied by the other departments in charge of the underlying business relationship. Unsurprisingly, the lawyers had few memories of these matters.

Pretenziyas in undisputed cases were either mandated by law or else formalized settlements already achieved on the ground. *Pretenziya* mandated by law mostly concerned quality and quantity deficiencies in goods under the so-called Instructions P6 and P7 – the Soviet bylaw of 1965 that regulated in detail the procedure for inspection of goods by the buyer. The Instructions prescribed that after a joint inspection of goods, the seller and buyer should sign an ‘Act of Deficiencies’. This was in essence a settlement agreement, in that the parties waived their rights to raise any claims other than those agreed in the Act itself. Following the Act, a *pretenziya* was sent out automatically and served to formalize the settlement.

Ukrainian law also mandates the prompt raising of a suit in trans-border debt cases. The Law ‘On Payments in Foreign Currency’⁵¹ aimed at suppressing money-laundering imposed fines on a creditor who has transferred payment abroad but failed to receive in exchange goods or monetary compensation within 90 days. Creditors who file a suit in court or invoke international arbitration are exempted from the fine.

To steer clear of this law, the Plant was obliged to initiate *pretenziya* against its parent company in Russia, a few of which actually ended up in court after the bankruptcy of the latter. Understandably, the debts in these cases were agreed, and were apparently aimed at so-called ‘tax optimization’ (i.e. tax evasion).

In the same way, the Plant used a *pretenziya* to formalize settlement agreements reached by its operational managers. A few examples include offsets of mutual claims,

⁵¹ The Law of Ukraine No 185/94-VR ‘On Payments in Foreign Currency’ of 23 September 1994 <http://zakon.rada.gov.ua>. The period for deliveries under cross-border contracts was changed in this Law from 90 days to 180 days in 2007; from 180 days to 90 days in 2009; from 90 days to 180 days in 2010.

price reductions on the next contract, the provision of additional services, the supply of extra inputs, and the renegotiation of specifications.

To sum up, a *pretenziya* in undisputed matters served as hard evidence of the problem and its solution, which could be exhibited to the accounting department, to upper management, or to the tax inspectorate.

Invented Legal Claims in Pretenziya as Bargaining Leverage

Many other creative uses of *pretenziya* by the Plant's legal counsel were triggered by changes of law. It is common knowledge that the Ukrainian government is constantly amending numerous laws and bylaws, mostly in the sphere of tax control. These changes negatively affected the dispute resolution practices of the sample companies. For example, within the period of this research the Plant underwent a change of the law governing bills of lading – the so-called TTN (*tovarno-transportnaya nakladnaya*). When the Plant realized that it was legally obligated to safekeep TTNs pursuant to the new regulations, it was already too late and a number of transactions with carriers had been executed without TTNs. When the sales people were unable to persuade their trading partners to supply the documents, the Plant's in-house counsel had to step in with *pretenziya*.

Although the Plant was at fault for missing the change in law and the carriers were not contractually obligated to do extra paper work for the Plant, lawyers turned things on their head in *pretenziya*. Despite the fact that the goods were in fact delivered to the Plant's buyers, the lawyers claimed that the lack of TTNs gives the Plant a formal ground to deem these goods undelivered. Therefore, the Plant demanded damages for 'non-performed' contracts. In this case the Plant's lawyers employed legal discourse and the legal form of *pretenziya* inventively, repackaging the controversy to look like a legal dispute. Here

pretenziya was being used essentially as ‘bargaining chips’ and the Plant eventually succeeded in collecting all the necessary documentation from the carriers.

Pretenziya as a Dilatory Tactic Used by the Respondents

Some companies who found themselves in financial distress treated *pretenziya* as an opportunity to play for time and to delay the final payment day. For want of a better alternative, the Plant had to rely upon this shady strategy as a survival kit.

Since 2009 the Plant’s payment practices have become chaotic and unpredictable, resembling the lottery. The popular joke of the 90s was recalled by the Plant’s lawyers when its situation sadly began to resemble that era in 2009:

The director of the company received a *pretenziya* demanding payment of debts to the supplier. The director answered: ‘If you ask for your money again in such a tone your *pretenziya* will be excluded from our premium drawing’ [Head of the Legal Department, the Plant, interview on 21 December 2010]

Given that ‘to pay or not to pay’ decisions were being made by one person – the General Director – under opaque criteria, the selection process was indeed akin to a lottery. After 2009 the Plant’s efforts have been redirected mainly toward a protraction of the disputes.

The Plant relied upon increasing numbers of suppliers in order to have at least two for each key input and to manoeuvre between them. When the Plant was overdue with one supplier and received its *pretenziya*, it turned to the other and vice versa. By doing so, the Plant effectively doubled the term of trade credit from its suppliers.

The Plant also differentiated between large debts to important trading partners and smaller debts to those who were expendable. *Pretenziyas* for important debts were settled

straightaway, sometimes through small but regular instalments, in order to complicate debt calculation and discourage the debtors from going to court.

Less important *pretenziya*, classified by the Director as ‘capable of waiting’, were sent to legal counsel with the implicit instruction to delay the payment by all possible means. The means of ‘legitimately’ delaying payment that the lawyers had at their disposal were few. Some of the *pretenziyas* the lawyers did not answer at all. The number in this category had doubled by 2011. Another lawyer’s trick was to wait until the time-period prescribed for answer had expired and only then to send out a formal letter requesting more documents to consider the *pretenziya*; otherwise they rejected the *pretenziya* on the technical grounds of a lack of documentation. As a last resort, the lawyers would answer *pretenziyas* without any definite payment promise,⁵² which meant nothing and in some cases prompted a second *pretenziya* from the creditor. In a few cases the number of *pretenziya* rose to three. The lawyers interviewed reported that the Plant usually paid straightaway after the third *pretenziya*.

Despite every effort utilising all possible strategies, the Plant was never able to escape payment for longer than a few months. While lawyers for both parties were engaged in a lengthy and senseless correspondence, the sales people often managed to negotiate settlements and the matter melted away. On still other occasions, dilatory tactics led events down a slippery path and the creditors ended up filing lawsuits in commercial court. From 2008 to 2011 the number of *pretenziyas* against the Plant increased fivefold and the number of court cases from zero in 2008 to four in 2011.

⁵² As an example of such terms here is a 2010 *pretenziya* answer of the Plant: ‘Our Plant sincerely appreciates the partner relationship that has been developed between our enterprises. At the same time, taking into account unstable financial situation of our enterprise, immediate fulfillment of financial obligations towards you is impossible. As soon as the financial conditions of the Plant improve, we undertake to promptly repay the debt’.

To conclude, although *pretenziya* is conventionally seen as the pressure to settle through the threat of court action, this study has identified the creative use of *pretenziya* for other than legal purposes. Around one half of *pretenziyas* studied in this research were used in the disputes with petty amounts of claim or in respect to the issues which were not actually contested by the parties. In these cases, *pretenziya* served as a tool to formalize a relationship, as a communication device, mediation technique or bargaining leverage.

The following section will analyze the actual use of courts where *pretenziya* failed to induce settlement.

7.2 Commercial Courts

7.2.1 Courts as a Contract Enforcement Mechanism

For a long time courts were seen by many researchers in economics, social sciences and law as the primary and often the only enforcement mechanism in contractual relations. The socio-legal perspective on courts introduced ‘a shift away from a focus on law as produced by the state and on trial courts as official sites for the practice of law to an approach in which legal reality is seen as a plural reality’ (Yngvesson 1990, p. 467-468). Thus courts began to be explored in conjunction with other extra-legal private contract enforcement mechanisms.

Within the broader system of private and public contract enforcement devices, the questions of researchers concerned their relative efficiency. Conventionally, administrative costs in terms of the length of court proceedings and court fees are considered to provide at least some ideas of the courts’ efficiency. Yet where courts are amenable to undue influence and corruption, neither prompt procedures nor cheap fees can serve the purpose of justice delivery. Thus measurements of speed and costs of court proceedings are not

completely comprehensive and should be supplemented by other perspectives. Deeper insights into the nature of courts within specific societal settings are provided by the study of their socio-legal functions (Lempert 1978, Hurst 1980).

In the context of business relations, courts are traditionally seen as state agencies whose primary purpose is to deliver justice to businesses – adjudicate disputes and safeguard fair compensation for wrongdoing from the defaulters. Apart from these functions of the courts, socio-legal scholars demonstrated other non-traditional uses of courts. First and foremost, the socio-legal approach to law highlighted the passive function of courts as the unspoken deterrent of deviant behaviour – the ‘shadow of the law’, which has a much greater societal impact than actual delivery of justice. As Galanter has observed:

The contribution of courts to resolving disputes cannot be equated with their resolution of disputes that are fully adjudicated. The principle contribution of courts . . . is providing a background of norms and procedures against which negotiation and regulation in both private and governmental settings take place (Galanter 1981, p. 42)

The scholars of relational contracting emphasized that in modern economies, owing to information and measurement problems, courts are unlikely fully to protect the contractual expectations of businesses through the application of contract law especially in long-term relationships. Therefore, the shadow of courts remains the major deterrent factor in the contractual relations of businesses. Even if the courts are incapable of making independent and fair decisions, or implementing them owing to corruption, the engagement in time-consuming legal procedures and possible costs of affecting the impartiality of the judge may deter opportunistic behaviour (Deakin *et al.* 1994, p. 337). Hence courts maintain ‘a vague sense of threat that keeps everyone reasonably reliable’ (Macaulay 1977, p. 519).

Where lawsuits are filed and courts actually get involved in the resolution of contractual disputes, their role may still be quite passive. Researchers highlight the present-day shift from adjudication to bureaucratic role of courts through the ‘rubber-stamping’ of uncontested debts (Macaulay 1977, p. 513-515) or ‘routine administrative processing’ of uncontested matters (Abel 1974, p. 228).

In certain types of contractual disputes, courts could serve as a means to evade responsibility. For example, where no official of the insurance company possesses the courage to write a check for substantial amounts of compensation, the court judgment provides such a justification (Macaulay 1977, p. 513-515).

Courts have been shown by many researchers to be employed by the parties to a dispute as the ‘weaponry in the process of dispute settlement’ (Macaulay 1977, p. 515). It is a well acknowledged fact that, for example, in US courts most cases settle short of a full-scale trial, and in most of them judges play no role at all (Trubek 1980, Galanter and Cahill 1993). In the latter part of the twentieth century, the courts’ busy caseload in developed economies of the common law world prompted a redefinition of the role of the courts, with settlement and efficient case management through Alternative Dispute Resolution techniques emerging as new key objectives (Palmer and Roberts 2005). Irrespective of whether the promotion of dispute settlement is recognized as an essential function of the state judiciary, the pressure to settle, exerted by courts at litigants, is evident in any societal setting.

Other ‘non-economic’ uses of courts came out of the research of Merry and Silbey, including besting someone in a situation unrelated to litigation, expressing feelings and letting off steam (Merry and Silbey 1984, p. 157).

In addition to the functions identified in developed economies, Hendley has found that apart from aspiration to recover money owed to them, Russian businesses were motivated to litigate by accounting or tax concerns because they saw the judgment of commercial court as a definitive proof to the state authorities that a debt was not illusory (Hendley 2004b, p. 54-55).

Thus in the context of business relations, courts serve first of all to adjudicate disputes and to secure fair compensation for the aggrieved party and thereby to deliver justice. In addition, courts are used by businesses in many other capacities – as a pressure to settle privately, as an emotional healing forum, as a means to evade responsibility, as a rubber-stamping machine in debt collection, and others.

Commercial Courts in the Post-Soviet Transition

The system of commercial courts in Ukraine as in other post-Soviet countries was inherited from the Soviet *arbitrazh* – a quasi-judicial administrative body that adjudicated disputes between socialist enterprises. Following the breakdown of the Soviet Union, *arbitrazh* has been transformed into proper courts charged with handling of commercial disputes of individual entrepreneurs, legal entities, and state agencies when the former act in commercial capacity (Hendley 1998, Belova 2005).

Many popular and policy-oriented accounts continue to represent post-Soviet societies as a lawless land with courts being hopelessly corrupt and inefficient (Polishchuk and Savvateev 2004, Gerts 2010, Pakhomov 2010). Yet businesses in Russia were demonstrated to rely extensively and increasingly upon the court system. Hendley and her colleagues were among the first researchers to unravel this contradiction using the official court caseload data as well as the findings of empirical research (Hendley *et al.* 2000, Hendley 2006). Later studies confirmed the increasing pragmatic reliance of Russian

businesses upon law and public courts, despite the popular perception of them as corrupt and inefficient (Vinogradova 2005, Gans-Morse 2011).

Similarly, Ukrainian commercial courts bear the reputation of one of the most corrupt and politically manipulated governmental institutions in the country (Cabelkova and Hanousek 2004). As Neil and Brook note, 'it is very well understood that the Ukrainian judicial system is corrupt, just as a tomato is red' (Neill and Brooke 2009). This perception is constantly reaffirmed by numerous opinion polls.⁵³

At the same time, surveys of Ukrainian companies demonstrate that businesses are not discontent with the courts. According to the 2007 IFC survey, Ukrainian businesses evaluated Ukrainian commercial courts as satisfactory, rating them 3 on a 5-point scale (IFC 2007). Naschekina and Timoshenkov reveal that Ukrainian business people do not see the need to improve the current court system (Nashchekina and Timoshenkov 2002). Moreover, despite Ukraine possessing one of the least favourable business environments in the world (rating 152 out of 183 in the 2012 World Bank 'Doing Business Survey'), it scored 44th on contract enforcement through the courts, outperforming Poland⁵⁴. Additionally, the surveys of Ukrainian businesses documented their willingness to turn to commercial courts (Johnson *et al.* 2002, Akimova and Schwodiauer 2005, IFC 2007).⁵⁵

This contradiction between the overwhelming popular distrust in courts and the pragmatic openness of businesses to using them when necessary was explained by Hendley

⁵³ Ukrainian business executives gave the independence of judiciary from political and other influences a score of 2.1 on a 7 point scale in the 2011-2012 Global Competitiveness Report <http://www.weforum.org/reports> (1 meant 'heavily influenced' and 7 'entirely independent').

⁵⁴ 2012 World Bank 'Doing Business Survey' <http://www.doingbusiness.org/data/exploreeconomies/ukraine/#enforcing-contracts>

⁵⁵ The official court caseload data does not allow concluding about increasing use of courts by Ukrainian businesses. Due to the changes of jurisdiction in 2006, a substantial portion of commercial caseload was transferred to the newly established administrative courts. Because the transfer was gradual and uncoordinated, official caseload statistics remains inconsistent and requires separate research. There are some indications that the number of applications to commercial courts in disputes on performance of contracts declined from 117,700 in 2004 to 86,700 in 2011. Ukrainian Judiciary http://court.gov.ua/sudova_statystyka/; Supreme Court <http://www.scourt.gov.ua/>

through the concept of the ‘dualism’ of courts where majority of cases are handled according to the law, but in exceptional cases an outside interference is accepted and the law begins to serve the political or economic interests of those with power (Hendley 2010a, p. 671). The mere prospect of manipulation in dual courts result in justice being ‘possible and even probable, but not assured’ (Hendley 2006, p. 351). Hendley’s empirical work demonstrated that ordinary Russians are well aware of the ‘dualism’ of courts and are able to adjust their behaviour depending upon which part of the dual system they are in (Hendley 2010a). The phenomenon of the dualism of the post-Soviet courts has only recently come to attention of researchers; Hendley’s works began only to ‘scratch the surface’ of this multifaceted complex phenomenon and more research is warranted (Hendley 2011a).

Rich empirical results gained within the five years of this study offer an ample ground to support Hendley’s ‘dualism’ thesis in respect to Ukrainian commercial courts. Businesses in this study were prepared to use courts and there seemed to be genuinely high chances to receive a fair and quick judgment, yet nobody was completely certain about this. As it was put by the interviewees: ‘You may or may not get justice in courts – it depends...’ [Farm Owner, interview on 26 July 2007]

With the concept of ‘dualism’ in mind, the inquiry into the use of courts by the researched companies in this study was aimed at paying equal attention to mundane as well as exceptional cases where a delivery of justice was distorted. The analysis was based upon the actual court experiences of the interviewees and the detailed examination of the court files and relevant materials at the researched companies. All together I have identified nineteen cases involving researched companies as claimants or respondents in Ukrainian

commercial courts, mostly in Donetsk: two of the Café (2004-2011), three of the Farm (2004-2011); and fourteen of the Plant (2007-2011).⁵⁶

Most of these cases went through the quick and affordable court system without any problems whatsoever. Yet seven (five)⁵⁷ of nineteen cases in the sample faced certain impediments caused by administrative resources invoked in courts or in the enforcement of court decisions, they are referred to in this study as the ‘red-button’ cases. The use of administrative resources in these cases was confirmed by the interviewees in all but one case where the fact of bribery was only alleged by the Farm Owner (Case No 2.1 Don Combine, Appendix 3).

Thus the sections below examine the various roles of courts in enforcing the contracts of the researched companies and the issues of the access, efficiency and effectiveness of commercial courts in mundane as well as red-button cases.

7.2.2 The Roles of Ukrainian Courts in Contract Enforcement

The deterrent effect of courts, emphasized by socio-legal literature (Galanter, 1981; Deakin, 1994; Macaulay, 1977), did manifest itself in this study. The importance of the courts ‘to be there’ was acknowledged by the interviewees, but the exact impact of the ‘shadow of the law’ was highly contingent upon the individual circumstances of the business relationship, and required additional empirical research. Other functions of Ukrainian commercial courts are discussed below.

⁵⁶ Two other court cases of the Plant were initiated outside Ukraine – in Russia and Georgia, and were therefore excluded from the sample of Ukrainian court cases.

⁵⁷ Although there were seven red-button lawsuits, in fact there were five cases, because due to legal technicalities two cases triggered two lawsuits each (Case No 1.1 ABZ and Case No 3.4 Leisure Park, Appendix 3).

Courts as a Bureaucratic Machine to Stamp the Claims

Most court cases of the researched companies represented a fairly straightforward dispute regarding non-payments and in a few cases non-performance of the commercial contracts.

Only two court cases regarding the Café's eviction from the Leisure Park (Case No 3.4, Appendix 3) raised the issues of the application of competing norms of the Land and Commercial Codes of Ukraine. The facts of contract performance were disputed in two other cases without any documentary evidence to support the claims (Case No 1.2 Dneprovsky, Case No 2.8 Valdi, Appendix 3).

All the debt collection cases were based on the valid written contracts signed and sealed by both parties, as well as a number of other documents of strict formal requirements – specifications, invoices, bills of lading, power of representatives to accept the goods, etc. The technical task of the claimants in these cases was to make sure that all these documents strictly correspond to the legal requirements, especially when they are put together, and include all cross-references. Respondents had to supply documentary evidence to the contrary. When the required documents were in place and their content was verified, all that was left to the judge was to confirm the amount of debt and the penalties.

Thus most court cases of the researched companies turned out to be undisputed debts. Respondents behaved in courts accordingly – they either recognized the claim as a whole; or satisfied the main debt and disputed only the calculation of the penalties, or have not showed up in court at all.

In addition, the bureaucratic function of the Ukrainian commercial courts became evident through the fact that absolute majority of judgments analyzed in this study were made in favour of claimants. Only two out of nineteen claims have been dismissed by the courts – the second commercial lawsuit in the Leisure Park Case (No 3.4, Appendix 3) and

the Dneprovsky Plant Case (No 1.2, Appendix 3). Indeed, official court statistics confirms that judgments in 78.5% of disputes are made by Ukrainian commercial courts in favour of the claimants.⁵⁸

As a rule, claimants were awarded the full amount of the debt claimed, although many altered their claims during court proceedings. Damages, including lost profit, were almost never sought by the claimants because the law required proof of a causal link between the damages and the breach of contract which was not an easy task. Lost profit was claimed as damages only in one case and was not awarded (Case No 2.1 Don Combine, Appendix 3). Instead, most judgments awarded the claimants nearly the complete amounts of penalties sought including interest and inflation compensation; as well as 100% of the court fees.

Thus in the absolute majority of court cases analyzed here the court had no chance to adjudicate. Instead, it played the role of a rubber-stamping machine in uncontested, mostly debt collection, disputes. The court stamp in these cases simply opened up an enforcement route through the State Enforcement Service (SES) for claimants, and it was not necessary for the majority of the disputants to dispute the law or even the facts. Two claims which dared to dispute the application of the law were manifestly red-button cases (Case No 3.4 Leisure Park, Appendix 3).

Use of Courts to Press for Settlement

In contrast to the judicial process for example in the US, where most court cases settle, the rate of out-of-court settlements in Ukraine is traditionally low. According to the 2007 IFC survey, only 7% of commercial disputes of the surveyed businesses settled after the initiation of lawsuits through an ‘amicable agreement’ (*mirovoye soglasheniye*).

⁵⁸ http://court.gov.ua/sudova_statystyka/

In line with these figures, three court cases of nineteen in this study – all of the mundane group – settled out of court. The case initiated by the Plant against the large factory was of an obviously relational nature (Case No 1.8 YuGOK, Appendix 3). The Plant was seriously interested in upholding the relationship with a large and prosperous customer. Its payment problems were caused by the change in ownership through a corporate raid. The new owners hoped to invest in the enterprise and restore its payment discipline. Given the nontrivial amount in the dispute, the court claim in this case was a clear pressure upon the new owners to settle. And it worked out – the parties settled before the judgment was made and the relationship was salvaged although slowed down for a while.

Why the two remaining cases have settled is less clear, because there was nothing distinctive about them. These two cases did not look any different from the cases which proceeded to trial. Alternative suppliers were available to the Plant and the relationships were terminated despite the settlements. The only likely rationale for settlement seems that the Plant in 2010 had more cash in hand than in 2011. According to the interviewees in this study, the creditors usually do not agree settlement offers and the courts do not confirm them unless the debt is actually paid. Even if the Plant wished to settle with its creditors out of court in 2011, it was simply unable to pay upfront.

Thus court proceedings in Ukrainian commercial courts have very limited power to induce settlements after court action is already initiated. Although limited, this function of Ukrainian commercial courts became evident only in respect to mundane cases.

Courts as a Dilatory Tactics Used by Respondents

Similarly to *pretenziya*, discussed in the first part of this chapter, the court as an instrument to delay the time of ultimate payment was expressly used by two respondents in this study,

and likely by some others. Although litigation was seen as an exceptional tool for this purpose, its use was justified by the pressing need for cash.

When the Plant was sued by its copper supplier for non-payment, the Plant's lawyers tried to delay court proceedings to make the most of the trade credit from this supplier without regard to the relationship. The Plant was aware that the supplier was under investigation by the tax inspection as one of the victims of the unofficial 'cleansing' of the copper market by the government. The Plant was determined to 'kill the relationship' and to 'end the game' with this supplier anyway; and therefore its only aim in court was to play for time and to use the credit to its advantage.

To delay court proceedings, the Plant made two separate payments to offset the debt after the claim had been initiated in court. Therefore the claimant had to recalculate the debt and the penalties and to resubmit the claim. Additionally, offset payments provided some room for negotiation and the Plant was able to decrease the penalties. As a result, the court procedures took more than two months which was valuable time for the Plant in its tough financial conditions. According to the Head of the Legal Department this strategy paid off:

We won anyway. If the Plant took a loan for this amount from the bank, the interest would have exceeded the amount of penalties awarded by the judgment [Head of the Legal Department, the Plant, interview on 18 October 2011]

Another case demonstrated similar motives of the Farm's respondent to delay court proceedings through illegal means (Case No 2.1 Don Combine, Appendix 3). The Farm alleged that the respondent bribed the judge to delay proceedings in order to avail itself of time to strip the assets of and to go into bankruptcy.

Thus, at least in two cases – one mundane and another red-button – respondents were able to delay court proceedings on purpose to improve their cash flow at the expense of the trading partner. In the mundane case, the respondent exploited the legal means to delay proceedings and was able to restrain the judge from making the ultimate judgement for 75 days; while in the other case it was allegedly the bribe which induced the judge to delay the judgment up to 180 days. Thus the alleged resort of the respondent to administrative resources in court allowed for the longest delay in court.

Courts as a Forum for Emotional Relief

Emotional relief through courts was obviously sought by litigants in this study only in two cases – one mundane and another red-button case. In the mundane lawsuit, the Farm reported that the respondent, its first-time supplier of petrol, felt extremely offended by the court claim of the Farm Owner (Case No 2.8 Valdy, Appendix 3). Notwithstanding the apparent futility of the attempts to prevail, the Valdy Director made his lawyer ‘die in court’ and to appeal the judgment through all court instances.

Revenge was also one of the motives that prompted the initiation of the second lawsuit in the red-button Leisure Park Case (No 3.4, Appendix 3). After the Prosecutor filed the court claim against the Café Owner on request of the Leisure Park and it was dismissed by the lower and appellate commercial courts, the Café Owner sued the Leisure Park to eventually ‘find some justice’ against it. Both commercial court cases and one criminal case originating in the Café’s eviction from the Leisure Park were exceptionally emotional.

Yet even in these cases it was clear that emotional satisfaction was only of secondary importance to claimants who were primarily motivated by profit considerations.

7.2.3 Access, Efficiency and Effectiveness of Ukrainian Courts

Having examined the various roles of commercial courts, this section looks at how efficiently and effectively commercial courts enforced the contracts of the researched companies in mundane and red-button cases.

Access to Commercial Courts

Ukrainian lawyers do not keep a monopoly on court representation. Any person – an in-house counsel, an accountant, a director, an owner or any executive of the company – can appear in courts on behalf of the company provided she is duly authorized. The statement of claim itself is quite concise – a few pages long; it refers only to the facts, documents and contains just a few references to law. Procedural rules are not dismissively complex and are comprehensible for lay people.

Although the new Ukrainian procedural codes attempted to depart from the Soviet style and shift the burden of proof entirely to the parties, my experience of observing five court hearings involving researched companies confirms that old practices persist. Judges continue to occupy a central place in proceedings by guiding the parties as to the procedural rules, by requesting additional documents, by ordering other motions and forgiving the legal ignorance of the parties. As a result the assistance of lawyers is less essential.

Indeed, in all but one court case, the research companies were able to represent themselves either through in-house lawyers or other employees of the company without hiring outside legal counsel, thereby eliminating much of the expense of litigating. The only case which required assistance of outside counsel was manifestly red-button case (Case No 3.4 Leisure Park, Appendix 3).

A second factor is that the costs of litigation in Ukrainian commercial courts were relatively affordable. The court fee paid before filing the lawsuit was not outrageously high although not trivial. Since November 2011 the court fee was raised from 1% to 2% of the claim.⁵⁹ According to the 2007 IFC survey, Ukrainian business estimated their costs for processing a case in commercial courts, including attorney fees, from 5 to 10% (IFC 2007). The estimate of the international surveys was much higher – 41.5% of the claim.⁶⁰ Even when attorney fees, which made more than a half in these estimates, were deducted from calculation, it still seemed to be overstated.

In any case, the 2007 IFC survey reported that the cost of court proceedings was of the least importance to Ukrainian businesses and they were most satisfied with it compared to other indicators of court efficiency (IFC 2007). This study confirms that researched companies have paid slightly more than 1% of the filing fees for each claim filed in commercial courts.

Efficiency – Duration of Proceedings

Ukrainian law places a limit of two months for the consideration of any commercial case in any of the three instances of the commercial court hierarchy. The official statistics provided by commercial courts is almost perfect, it indicates that only 0.02% of cases in commercial courts of the first instance take longer than statutorily prescribed, although these statistics do not include stays for exceptional reasons.⁶¹

According to international surveys, the length of Ukrainian court proceedings, including the time for enforcement of judgements, was estimated to be between 224

⁵⁹ The Law of Ukraine No 3674-VI ‘On Court Fees’ of 8 July 2011 <http://zakon.rada.gov.ua>

⁶⁰ For comparison, average Eastern European cost is 26,6%, average OECD cost is 19,2%. See <http://www.doingbusiness.org/data/exploreeconomies/ukraine/#enforcing-contracts>

⁶¹ http://court.gov.ua/sudova_statystyka/556457874511/

(Djankov *et al.* 2003, p. 494) and 343⁶² days, substantially lower than the average identified by these international surveys for Eastern Europe (327 and 412 days respectively).

Given the straightforwardness of the most court cases in this study, the court proceedings in analyzed cases were completed on average during four court hearings. The duration of court proceedings was found to be almost two times shorter than the assessments of the international surveys. While court proceedings in red-button cases took one and a half times longer than mundane proceedings, the average duration of the court proceedings for all types of cases, including the service of process, trial and enforcement, still did not exceed 146 days (See Table 7.2 below).

⁶² 2012 World Bank 'Doing Business Survey'
<http://www.doingbusiness.org/data/exploreeconomies/ukraine/#enforcing-contracts>

Table 7.2 Duration of Court and Enforcement Proceedings in Commercial Courts of the First Instance (calendar days)⁶³

	For mundane cases	For red-button cases	For all cases
Average duration of proceedings from submission to the first hearing	14	14	14
Average duration of trial	55,8	82,1	65,5
Average duration of implementation of decisions	66,2	Not implemented	66,2
Total average	136	NA	145,7

Additionally, this study reveals that judgments in the cases of the researched companies were rarely appealed. Only in three out of nineteen judgments did the losers file appeals in the second and the highest instances of commercial courts. One case was purely emotional and had no legal grounds behind the appeals (Case No 2.8 Valdy, Appendix 3), and two others were red-button cases (Case No 3.4 Leisure Park, Appendix 3).

Thus the findings of this study confirm that problems of excessive costs and cumbersome procedures are not comparatively significant problems for Ukrainian commercial courts. Yet this is not the whole story – gaining access to courts is a hollow victory if the courts are incapable of delivering fair and just decisions or implementing them.

Corruption in Commercial Courts

This study reveals that majority of litigants in this study went through the court system without being compelled or induced to bribe the judge or to influence her in any other way. The overwhelming opinion of the interviewees in this study was that corruption generally

⁶³ Source: Data drawn from author's fieldwork. Calculations are made in accordance with the methodology described in Djankov *et al.* 2003.

does not work anymore for straightforward debt collection disputes in commercial courts. At the same time, the possibility of corruption in courts was not excluded and became evident in three red-button cases.

Notwithstanding its rare use, this study highlights that access to the red button of administrative resources in Ukrainian commercial courts was open for anyone who was able to pay its high price. It was not confined only to political or high stake cases, such as charges against Khodorkovskiy in Russia or large scale corporate raids. Political pressure upon Ukrainian commercial courts, although not excluded, was currently less likely. Since 2006, administrative disputes involving state agencies, such as tax inspectorates, were adjudicated in separate administrative courts. Despite the essential portion of court cases susceptible to undue influence being removed from commercial to administrative courts, this study demonstrates that the red button still remained in commercial courts and was actually activated after 2006.

In line with the previous studies (Akimova and Schwodiauer 2005, Kurkchiyan 2007), corruption in commercial courts was uncovered in two forms – through direct monetary bribes and through informal connections with local governmental officials. The latter was also known as ‘telephone law’ – ‘a practice by which outcomes of cases allegedly come from orders issued over the phone by those with political power rather than through the application of law’ (Hendley 2009b, p. 241).

In the Don Combine Case (No 2.1, Appendix 3) the Farm’s respondent was alleged to have paid direct monetary bribe to the judge, whereas in two other red-button cases (the Café’s Leisure Park Cases) these were various state organs that exerted pressure upon the judge. For example, the Café Owner reported that:

There was a lot of pressure upon the judge. A friend of my attorney has learnt that he had been telephoned many times [Café Owner, interview on 20 October 2009]

Where a monetary bribe was allegedly paid to the judge, it was aimed at delaying proceedings in courts, and where informal connections were activated, they were seeking to influence the content of judgments.

Thus in line with the research of Russian courts (Kurkchiyan 2007, Hendley 2009b), this study identified that the red button of undue influence on courts was in principle accessible for all litigants capable of paying for it, but it was not invoked often.

Enforcement of Judgments

The problem of the implementation of court decisions was seen as the most troublesome by all the surveys of Ukrainian business and by the interviewees in this study alike.

The process of enforcement of judgments in Ukraine has a few peculiarities, unknown for legal systems in developed economies. The enforcement of judgments of all courts in Ukraine is entrusted to the separate administrative agency under the Ministry of Justice unconnected to the courts – the State Enforcement Service (SES). Before taking affirmative action to collect the debt, the creditor must wait ten days for the judgment of the commercial court of first instance to take an effect. If the parties do not file an appeal and the debtor does not pay the judgment within this period, the creditor receives the enforcement order (*ispolnitel'nyy prikaz*) of the court and may turn to the SES. The SES has a right to initiate enforcement proceedings under request of the debtor as early as on the eleventh day after the judgment is made. The local SES department informs the debtor of the commencement of enforcement and grants seven days for the final attempt at voluntary execution.

Ukrainian creditors do not enjoy the opportunity to enforce judgments through the banks of the debtors bypassing the SES, all the collection efforts must be undertaken through the SES.⁶⁴ The SES has a power to seize the bank accounts of the debtor which so far is the most effective measure. The sale of the debtor assets, although permitted by the law, is seen as impracticable and too burdensome a procedure, which rarely brings the desired result. Where the SES bailiffs delay their service, the only recourse of the creditor is to complain to the courts or to the Prosecutor office.

In my attempt to assess the level of enforcement of judgments by Ukraine's commercial courts, I failed to identify any reliable official source of statistical information. The Ministry of Justice publishes some statistical reports on its website; however, it is impossible to disentangle the data on commercial courts from the data on other courts in those reports. The High Commercial Court reported through a press release that in 2009 only 10-30% of judgements in commercial cases were enforced by the State Enforcement Service, with Donetsk Region having the highest rate in Ukraine – 38.2% (Shevchenko 2009). However, data on the number of voluntary executions by the debtors was missing in all sources.

The mass media continuously points to the failure of the enforcement system in Ukraine. Many Ukrainian judges, state officials and journalists declare it to be 'in a critical state' (Vlasov 2007, Shevchenko 2009). Press releases emphasize the fact that two thirds of the decisions of the European Court of Human Rights against Ukraine concern the poor enforcement of court decisions.

At the same time, empirical surveys report some positive trends. According to Akimova and Schwodinauer, among the firms that used commercial courts in their study,

⁶⁴ The Law of Ukraine No 202/98-VR 'On State Enforcement Service' of 24 March 1998 <http://zakon.rada.gov.ua>

43% reported that debts were already repaid by their contracting partners, 30% were waiting for the positive decision of the court to be implemented, and 27% were waiting for the court's decision (Akimova and Schwodiauer 2005). The 2007 IFC survey revealed that 46.3% of the companies had judgements in the last dispute completely enforced, and 17.6% partially enforced; all together this made for almost a 64% enforcement rate (IFC 2007).

As Table 7.3 demonstrates, the researched companies in this study were able to collect 62.5% of the judgments in full, which corresponds to the rates identified above. The rest of the judgments were not enforced at all, confirming the 'all or nothing' pattern identified by Hendley in the context of Russian business (Hendley 2004b). Out of the unenforced judgments, only one had some prospect of partial enforcement through in-kind contributions of the debtor to offset a two-year old court decision (Case No 1.1 ABZ, Appendix 3).

Table 7.3 Outcomes of the Court Cases and their Enforcement by May 2012⁶⁵

	Plant	Farm	Café	Total for three companies	%
Judgments in need of enforcement	13	3	0	16	100
Of which were:					
a) non-enforced	5	1	0	6	37,5
b) settled and executed in courts	3	0	0	3	18,75
c) executed voluntarily after the judgment was made	2	1	0	3	18,75
d) executed voluntarily after the SES initiated enforcement proceedings	3	0	0	3	18,75
e) enforced by the SES through seizure of the bank accounts	0	1	0	1	6,25

⁶⁵ Source: Data drawn from author's fieldwork.

Among the enforced court judgments, the majority were executed voluntarily by the debtor – either in courts (three judgments), after the judgment was made (three judgments), or after the SES had initiated enforcement proceedings and offered a one-week compliance term for the debtor (three judgments). The SES actually had to seize the debtor’s bank accounts in only one of the sixteen judgments which required enforcement (Table 7.3).

Thus out of ten judgments submitted for enforcement to the SES, six remained unenforced. This makes a 40% enforcement rate through the SES, which is in line with official statistics reporting more than a 38% success of SES enforcement in Donetsk region (Shevchenko 2009).

The important finding of this study is that out of six unenforced court decisions, two were unenforced owing to the debtor’s bankruptcies, and four judgments remained unenforced due to administrative resources invoked by the debtors.

The example of the active use of administrative resources at the enforcement stage was offered by the Café’s Leisure Park Case, where it came as no surprise because the local authorities relied upon this from the very beginning of the controversy.

The resort to administrative resources at the enforcement stage in the ABZ Case (No 1.1, Appendix 3) was more unexpected. The respondent – the private ABZ company – did not show up at the court hearings, and both judgments were made by default in favour of the Plant. When it came to enforcement, the SES was apparently unwilling to make proactive steps to collect the debt. The Plant’s lawyers initiated complaints to the Prosecutor office which did not help. Finally, when it became obvious that ‘there is something wrong’, the Plant’s Vice-Director for Economic Security conducted a private investigation and discovered that the debtor was protected by a roof (*krysha*) by the Security Service of Ukraine – one of the powerful state agencies, the former KGB. The

Security Service apparently communicated to the SES the ‘undesirability’ of enforcement regarding the ABZ. Eventually, after almost two years of enforcement efforts, the Plant was able to settle with the ABZ for an in-kind contribution. Since February 2011, the ABZ began to supply the construction materials to the Plant in small parts to offset the court decision made in April 2009.

Passive resistance to the enforcement of court decisions through the statutory ban of enforcement was exhibited by two other of the Plant’s debtors – the state-owned coalmines DUEK and Rovenki. Through a clear understanding of all the parties to these disputes, the debts of the coalmines were ‘dead’ and the whole court affair was simply a formality.

Thus the use of administrative resources in the enforcement of judgments proved to be as ‘effective’ as within the court proceedings. Moreover, it was reported by the interviewees in this study that it became increasingly attractive. Owing to court reforms or to other factors, direct monetary bribes in commercial courts became too costly for businesses. Only the large companies with a sufficient stakes in disputes, such as corporate raids or bankruptcies, could afford to influence the content of the judgment. As explained by the interviewees in this study:

It is cheaper to bribe the local State Enforcement Services (SES) because bailiffs (*ispolniteli*) are hungry. They are happy with hundreds of hryvnias while you cannot approach the judge with anything less than three thousand American dollars [unnamed interviewee, interview on 26 October 2011]

There are cases when one is not able to collect the debt under the judgment at all, because the state organs, which serve as a roof to the debtor, simply do not allow the State Enforcement Service to seize the bank accounts or to collect the debt in other ways [unnamed interviewee, interview on 16 August 2011]

To conclude, although this study has identified a fairly high rate of judgment enforcement – 62.5% with nearly a complete collection for each judgment⁶⁶ – it also spotted that enforcement became the weakest stage of court proceedings seriously exposed to the undue influence of debtors. The use of the administrative resources during the enforcement of court decisions through the SES turned out to be more practicable than manipulating the content of the judgment or procedures in courts.

7.3 Conclusions

This chapter looked closely at the nature and operation of contract enforcement through the courts and court-related mechanisms of the pre-trial claims (*pretenziya*). From the outset it should be reiterated that these mechanisms are treated by Ukrainian businesses as the last resort where private contract enforcement mechanisms fail to produce a settlement. *Pretenziyas* were used by the researched companies only in 0.32 %, and courts in 0.09% of the transactions of the researched companies (Appendix 2).

⁶⁶ When the judgments against the state-owned enterprises, which are currently non-enforceable by law, are excluded from the sample, the enforcement rate rises to more than 70%. Interestingly, Hendley's study of judgment enforcement by Russian enterprises largely corresponds to the above results on Ukrainian courts with a 65% enforcement rate, although Russian creditors recovered on average less than half of the judgment (Hendley 2004, p. 75).

Pre-trial claim settlement through *pretenziya* – a formal letter containing legal claims – was analyzed in this study separately from the courts, which allowed me to discern the multiple legal and extra-legal functions of *pretenziya*.

Pretenziya was seen by those interviewed for this study as the threat of court action when the amount of the claim was substantial and the disputes were caused by circumstances not easily ameliorated by the parties. Such circumstances included those beyond the control of both parties (*e.g.* governmental decrees, global warming); and the genuinely distressed financial situation of the defaulter, which was recognized by all parties as distinct from active opportunism. In these cases, it was indeed expected that *pretenziya* would induce the defaulter to ‘come to her senses’, to satisfy the claim voluntarily and thereby avoid even greater losses in court from contractual penalties and court fees.

While all the *pretenziyas* served by or against the Café and the Farm were strictly within the bounds of the legal functions of *pretenziya* discussed above, only one half of the Plant’s *pretenziyas* were intended as *bona fide* threats of litigation. The other half provided extra-legal functions in disputes with petty amount of claims, in uncontested matters, or where litigation was pointless. This study has uncovered a number of rationales behind these seemingly wasted efforts.

First, when settlements were reached on the ground by sales people, *pretenziya* served as forensic evidence for accounting purposes to formalize the newly restructured business relationship. Second, when the amount claimed was trivial – so-called ‘tails’ which arose from technical problems or human misunderstandings – *pretenziya* served primarily as an attention-grabbing device and as a signalling tool to break through to the main decision-makers, the general directors. Third, when problems were caused by both sides and emotions ran high, *pretenziya* played the role of a mediation technique and a

quasi-legal discovery procedure to clarify the situation. Often the information obtained in this way by in-house lawyers was sufficient to put an end to the dispute. Fourth, in certain cases *pretenziya* was used creatively as a ‘bargaining chip’ which repackaged seemingly groundless claims into ‘nuisance’ legal disputes. Fifth and finally, respondents in *pretenziya* (for example, the Plant in the aftermath of the 2008 world financial crisis) took a defensive stance and exploited *pretenziya* as a dilatory tactic to improve their own cash flow at the expense of their contracting partners.

This spectrum of the extra-legal functions of *pretenziya* illuminates its mixed nature and offers one possible explanation of its persistence in post-Soviet business. Owing to its adaptability, *pretenziya* is capable of operating both as a token of the public order – the ‘shadow of the law’ – as well as a part of a private contract enforcement. In the latter case the expressly legal form of *pretenziya* was not necessarily seen as insulting the trading partner. Conversely, it was perceived as facilitating the debt collection process through enhanced communication between the parties. Thus *pretenziya* in a voluntary form has not only survived but even opened up new avenues for the creative use of legal forms in business.

The second part of Chapter 7 analyzed the public contract enforcement mechanism of commercial courts. A close examination of Ukrainian courts’ role in the contract enforcement of the researched companies revealed their passive stance in the adjudication of contractual disputes. Given that in the absolute majority of court cases respondents either did not contest the debts or did not show up in courts, commercial courts had to simply rubber-stamp uncontested debts based on the documents supplied. In the minority of the court cases of the researched companies, the courts were used as settlement pressure at the contracting parties, as a dilatory tactic to improve their own cash flow at the expense

of the trading partner, and as a forum for emotional relief. Finally, ‘the shadow of the law’ was definitely present in the business relationships of the researched companies, however, the degree of its deterring impact remained unclear calling for additional research with elaborate methodology.

Having examined the question of the role of commercial courts in the contract enforcement of the researched companies, this study addressed the issue ‘how efficiently courts enforced a contract’. It revealed that a chronic inefficiency might have been overestimated by popular accounts and some academic research.

According to the data obtained in this study, proceedings in the first court instance did not exceed 80 days (from filing a claim in courts to the date of judgment); enforcement of judgment took on average 66.2 days. As a rule, no appeals were lodged. The direct costs of the court cases did not exceed 1,5% of the claim and in all but one case external legal counsel was not involved. In 62.5% of judgments, the claimants were able to collect 100% of the compensation, which was paid by the debtors voluntarily either in courts, after the court judgment was made or after the SES had initiated enforcement procedures. On average the researched companies had rather a positive experience in dealing with Ukrainian commercial courts. In most cases claimants were able to obtain a quick and fair compensation and recover the full price of the goods, as well as penalties, interest rate, inflation index and court fees.

Thus the findings of this study suggest that Ukrainian commercial courts are generally up to the task of providing speedy compensation to businesses. Although most of the cases analyzed here were straightforward debt collections which required neither pre-

trial attachments nor expert witnesses, commercial court statistics confirms that such disputes make the largest part of the caseload.⁶⁷

Looking at the court cases of the researched companies through the concept of dualism, suggested by Hendley (Hendley, 2006), reveals that indeed most of them were mundane cases and around one third were red-button cases where administrative resources were activated by one of the parties to the dispute.

Although not used often, data obtained through the fieldwork of this study suggests the pragmatic and ‘accessible’ (in inverted commas) nature of the use of administrative resources offered to litigants by Ukrainian commercial courts. All types of business relationships and all types of court cases proved susceptible to manipulations through the use of state machinery. However, litigants who already possessed access to administrative resources of the state – state agencies, state-owned enterprises and ‘muddy’ private companies – were most likely to invoke it in courts. Moreover, this study also demonstrated that it was possible for those who had not previously resorted to this to buy one-time access to administrative resources in courts.

The efficiency of judiciary in red-button cases was expectedly lower than in mundane cases. Red-button cases were considered by courts on average within 82 days, compared to 56 days in mundane litigation. Claims in the red-button cases were more likely to dispute law and facts of contractual performance and to involve extra costs for parties to finance external legal advisors. Judgements in the red-button cases were more frequently appealed.

⁶⁷ In 2011 the caseload of the first instance commercial courts comprised: 68% - disputes on performance of commercial contracts (64% of these – payment disputes); 11,2% - disputes on formation, termination and validity of commercial contracts; 7,7% - bankruptcies; 1,6% - validity of administrative acts; 11,2% other non-contractual disputes <http://www.scourt.gov.ua>

Administrative resources in the red-button cases were used in several forms. When administrative resources were activated in courts, this was done either through monetary bribes or through administrative pressure on the judge, and was aimed either at subversion of the content of the judgement, or at the delay of the proceedings. At the stage of judgment enforcement, apart from monetary bribes and administrative pressure at the State Enforcement Service, debtors – namely all the state-owned enterprises – relied upon a statutory ban of the seizure of the state property. Resort to administrative resources to resist the enforcement of court decisions turned out to be even more ‘effective’ in the subversion of justice than using administrative resources in courts. As a result, absolutely all the judgments in the red-button cases analyzed in this study remained unenforced.

Thus the fair enforcement of contracts in Ukrainian commercial courts was probable but not completely assured owing to their dualism.

CONCLUSIONS

This thesis explored the various mechanisms that Ukrainian businesses employ to enforce contracts among themselves, the configuration of these mechanisms and their actual operation to ensure the stability of contractual relations in a transition economy. Having examined the contractual pattern that is prevalent in low-technology moderately competitive industries which are characteristic of the Ukrainian market as a whole, it is now time to reflect upon my research findings to infer answers to the questions asked at the beginning.

Given the deeply seated stereotypes about dysfunctional courts and the high level of contractual violations in post-Soviet business, the first question to be answered is how effective and stable is the observed contractual pattern in contemporary Ukraine?

This study reveals a generally trouble-free picture of contract enforcement within the observed contractual pattern. Contracts were generally complied with – only 6.5% of transactions were executed with problems, defined as any deviation from the written contract beginning with one day of delay and so on. Claims were raised and communicated expressly to trading parties and most contractual problems were fixed quickly through bilateral negotiations between operational level managers. Only 0.35% of transactions required the assistance of lawyers, and 0.09% ended up in courts. Out of those cases submitted to commercial courts and which resulted in judgments, two thirds enjoyed quick and affordable court proceedings with full compensation being paid within less than two months of the judgment.

The relatively unproblematic enforcement of contracts in the last decade gave rise to greater trust between trading partners, which could be seen as another indicator of the

stability of contractual relations in Ukraine. Contrary to the assumptions of earlier research on the post-Soviet transition about the scarcity, or even absence, of bilateral trust (Humphrey and Schmitz 1998, p. 42, Radaev 2000, p. 14, Oleinik 2005, p. 7, Jansson *et al.* 2007, p. 965), interviewees in this study indicated that they trusted nearly all of their trading partners. Active opportunism – ‘lying, stealing and cheating to expropriate advantage from contracting partner’ (Woolthuis *et al.* 2005, p. 813) – was found to be largely absent in business relationships. Contracts were expected to be honoured, and relationships evolved in a generally trustful atmosphere.

These findings offer strong grounds to answer the question about effectiveness of the observed contractual pattern in the affirmative. Given this finding, it is not surprising that the demand for new institutions, such as mediation or for an improvement in commercial court services, is low in Ukraine. Yet this finding does not reject the possibility of such a demand in specific economic sectors or specific business relations which lie outside the contractual pattern examined in this study; this question requires additional research.

The questions posed in this study are how the effectiveness of the observed contractual pattern was achieved, and what are the specifics of the contract enforcement mechanisms employed by Ukrainian businesses to support their contractual relations?

This study identified an autonomous self-sustaining system of private contract enforcement mechanisms in Ukrainian business, complemented by an alternative system of commercial courts coexisting and reinforcing each other. Although the general contours of this system are by and large similar to those in traditionally stable industries in the North American and European economies (Macaulay 1963, Arrighetti *et al.* 1997, Hadfield and Bozovic 2012), as commented by Hendley, beyond this superficial similarity there are

profound differences (Hendley 2001). The following sections summarize the specifics of the mechanisms that ensure the high level of contractual compliance in Ukrainian business, and explain this with reference to the various factors of the wider business environment.

Written Contracting

One of the acknowledged particularities of post-Soviet business refers to the preference of businesses for written contracting. This study confirms an unusually high, by the standards of developed and developing economies, use of written contracts in Ukraine covering up to 80% of transactions.

Given that courts were used in around 6% of disputes and that the signing of contracts did not automatically translate into a reliance upon them, the question here is why businesses sign contracts with little expectation of turning to the courts to enforce them?

This study reveals that written contracting in Ukrainian business proved to be largely a product of Soviet legacies and state policies towards businesses. It was embedded in the organizational routine of many industrial enterprises since Soviet times. The requirements of current Ukrainian taxation and accounting regulations have enhanced the propensity of businesses to transact within the frameworks of written contracts. Apart from the direct imposition of the written form by taxation regulations upon many transactions, frequent extortions by taxation inspectorates and other state agencies have prompted the use of written contracts as a shield against the rent seeking of governmental officials. Court recourse, albeit having a secondary importance, was not excluded by businesses from consideration, even at the stage of initiation of transactions.

Thus taxation regulations, fiscal control and the threats of unofficial state extortions induced and routinized formal written contracts, and thereby indirectly contributed to contractual certainty in Ukrainian business-to-business relations.

Repeated Dealings

Contrary to the assumption that high macro-level uncertainties prevent post-Soviet businesses from relying on repeated interactions (Humphrey and Schmitz 1998, p. 43, Nashchekina and Timoshenkov 2002, p. 4), repeated dealings was a certain ‘leader’ among contract enforcement mechanisms identified in this study. Indeed, repeated dealings made a foundation for all other mechanisms safeguarding contractual compliance in the business relations of Ukrainian companies.

In the Ukrainian business context, which is typically constrained by a semi-competitive market, this mechanism relied more on positive incentives such as a discounted stream of trade and the technological need for repeated purchases, rather than the threat of relationship termination. Actual terminations of business relationships caused by a defective contractual performance were found to be extremely rare. Where terminations still took place, they were often unspoken, implicit, hardly identifiable and revocable. Court recourse was not excluded even in relational contracting and did not necessarily put an end to the relationship. In one third of the court cases involving the researched companies, business relationships outlived court judgements, corroborating similar findings by Hendley made in the context of Russian business (Hendley 2004a, Hendley 2011a).

The specifics of repeated dealings in Ukrainian business concerned their coexistence with written contracts, which was in line with the recent research on formal contracts in developed economies (Deakin *et al.* 1994, Arrighetti *et al.* 1997, Poppo and Zenger 2002, Woolthuis *et al.* 2005, Gilson *et al.* 2009, Gilson *et al.* 2010, Dietz 2012, Hadfield and Bozovic 2012). However, this coexistence displayed notable characteristics. Entrenched in long-term informal continuous relationships lasting on average from five to

seven years, most transactions by the researched companies were nevertheless covered by written contracts.

Most written contracts examined in this study were concluded as a concise, relatively complete single document signed and sealed by both parties for duration not exceeding twelve months, often in the form of the framework contract appended by a number of specifications. Contracts were usually performed within weeks if not days, trade credits and prepayments on average did not stretch longer than eight days. Contracting parties mindfully avoided clauses that formally tied them beyond the current transaction. Contracts were confined only to basic contractual terms, did not generally include saviour or contingency clauses, and were freely renegotiable at any time. Technical cooperation in the design of traded goods, the joint training of personnel, and the sharing of information and technical expertise were uncommon and totally omitted in written contracts. Reviewed contracts did not reflect any degree of relationship-specific investment by the trading partners into productive assets or human capital. Informal interdependency within business relationships was also minimal – neither family nor ethnic ties, nor social norms of collective punishment of cheaters tied the researched companies and their trading partners.

The minimal degree of formal and informal interdependency between trading partners identified by this study owes a lot to high uncertainties of the economic, political and regulatory environment in Ukraine aggravated by the permanent threat of state extortion – state *bespredel*. The highly volatile environment prompted businesses to stick to the known and safer option of trading with regular partners and precluded an interdependency even between long-standing trustful partners. Instead of careful planning for future contingencies, contracting parties preferred to avoid them all together by shortening the time horizons for formal transactions akin to the spot-market.

The technological specifics of standardized production entailed a need for standard repeated purchases and therefore enhanced continuous interactions between trading partners. However, low production technology and negligible product customization made it easier to verify the quality of products and to avoid interdependency between trading partners.

In a similar vein, the semi-competitive market prompted the tolerance of contractual defaults by ‘conditionally blacklisted’ regular trading partners and made express irrevocable terminations of business relationships unfeasible, but did allow for new entry and induced contractual compliance through the threat of withdrawing immediate short-term business opportunities within tentatively preserved long-term informal relationships.

Thus the low level of interdependency in the repeated dealings of Ukrainian companies could be explained by the inconsistent impact of the wider business environment, which simultaneously dictated to stick to known trading partners but not to depend on them.

Finally, repeated dealings, conventionally attributed to relational contracting between regular trading partners as its characteristic feature, in the context of Ukrainian business projected a ‘shadow’ even across discrete contracting between first-time trading partners. Given the limited choice of alternative trading partners, most first-time business interactions were inspired by potential continuous business opportunities. More deliberately repeated dealings were employed in discrete contracting through the strategy of breaking one transaction into a series of identical smaller ones. This strategy effectively transformed the discrete one-off interactions of Ukrainian businesses into a repeated game.

Thus repeated dealings bound only by a minimal formal and informal interdependency between trading parties were relevant both to relational and discrete

modes of contracting and exhibited a high level of flexibility and adaptability in Ukrainian business.

Self-Enforcing Devices

Apart from repeated dealings, the contractual pattern identified in this study relied heavily upon self-enforcing devices – ‘technical’ financial and logistical arrangements which secured an unconditional contractual compliance by resorting to incentives outside the business relationship.

Contrary to the assumption that with the end of central planning *all* contract enforcement mechanisms collapsed (Murrell 2008, p. 683), this study reveals that quality promises in the discrete and relational contracting of Ukrainian companies continued to be supported by state certification, pre-sale sampling, and post-sale verification – institutions dating back to Soviet times which remained largely unchanged in two decades of transition. Given the low level of technology, these public institutions, although requiring substantial reforms, still ensured some contractual certainty. Additionally, the most powerful incentive to honour quality promises stemmed from the asymmetry of the Ukrainian market where a greater number of suppliers competed for fewer buyers.

Except for the cash-operating industries, such as the retail trade of the Café, enforcement of payment obligations within the observed contractual pattern was largely confined to prepayment. Around 60% of the Plant’s and Farm’s contracts contained either full or partial prepayment clauses which operated differently for discrete and relational contracting.

In discrete contracting, nearly all first-time buyers had to pay upfront for goods and services. In line with the previous post-Soviet studies, prepayment requirements were gradually relieved in the process of repeated dealings.

Although prepayment was primarily employed in discrete contracting, various types of prepayment clauses were included into one-fifth of the Plant's and Farm's contracts with their regular trading partners. This fact, taken by some researchers as a manifestation of deep mistrust in post-Soviet business (Radaev 2004, p. 9), in reality reflected conditions of wider business environment and often indicated the trusting nature of Ukrainian business relations. In an almost complete absence of bank loans, researched Ukrainian companies were involved in mutual funding. Therefore, in contracting with regular trading partners where concern for future interaction was dominant, prepayment operated first of all as a credit device and as a part of bargaining. On rare occasions prepayment was used in relational contracting as a punishment for defaults in previous transactions. Thus, although it played a secondary role, prepayment still advanced the enforcement of contracts in relational contracting. Taking into account the pessimistic prospects for the development of the Ukrainian banking system, prepayments are likely to continue to dominate contract enforcement and contribute to its effectiveness.

Reputation and Personal Relations

This study has identified the marginal role of reputational mechanisms in Ukrainian business which only slightly enhanced contractual compliance by contracting parties. Reputational mechanisms were confined primarily to rudimentary uncoordinated gossip which exhibited notable deficiencies of information flows. Although reputational information about quality was shared more readily than information on payment practices, the researched businesses were reluctant to spread *on purpose negative* information about their trading partners, even within the immediate business network. The idea of collective reputational sanctions was rejected by the interviewees as unnecessary in an environment dominated by self-enforcement and repeated dealings with the same trading partners.

In some discrete transactions, when relationships were just initiated, the mechanism of branding was employed by the parties. A few large Ukrainian and international corporations enjoying a dominant market position and the reputation of highly trustful trading partners were capable of escaping prepayment in first-time transactions. Yet apart from a few brand-name holders, none of the researched companies or their trading partners was capable of relying solely on their reputations in first-time transactions.

Contrary to the assumption that businesses in developing and transition countries routinely screen each and single new trading partner for reliability (Fafchamps 1996, Vinogradova 2005), this study documented the decline of reputational screening in Ukrainian business. The screening of potential trading partners through Internet research, business associations or enquiries of established trading partners was demonstrated to have lost its importance.

Finally, personal relations, although detectable, were found the least valuable contract enforcement mechanism. This is not to say that contracting was maintained on a purely impersonal basis. The personalized nature of business interactions was retained in Ukrainian business but it was confined to professional interactions which stopped short of the 'sauna and vodka' meetings of the Soviet epoch. Family and friendship links were consciously avoided in business-to-business relations.

Thus reputational mechanisms and personal relations were found unable to replace repeated dealings and self-enforcing contractual devices; they impacted contract enforcement indirectly through enhancing bilateral trust between trading partners.

Third-Party Private Enforcement

In line with other studies of the post-Soviet transition (Hendley *et al.* 2000, Hendley and Murrell 2003, Schonfelder 2007), private third-party mechanisms were found virtually absent from the contract enforcement picture of the researched Ukrainian companies.

Business associations that came out in this study did not offer dispute resolution services to their members, neither did they publish blacklists, disseminate reputational information, or exclude companies from their organizations for contractual misconduct. This study notes that Russian companies in the same industry as the researched Plant – cable manufacturing – actively resorted to business associations and Internet forums, and were more willing to rely upon collective reputational punishment. It is likely that the higher competition on the Russian market and its greater size contributed to more diverse enforcement mechanisms in Russian business relations – an area which could be a challenging topic for future comparative research.

Notwithstanding the efforts of foreign donors and several local NGOs to establish mediation practice in Ukraine, the private mediation of commercial disputes remained a novel idea among businesses.⁶⁸

Private international arbitration was the preferred dispute resolution method in the formal contracts of the researched companies with their foreign trading partners, but was never actually resorted to. Private domestic arbitration was treated by the interviewees with hostility and suspicion. Although the Law ‘On *Treteyskiy Sud* (Domestic Arbitration)’⁶⁹ has

⁶⁸ Since late 90s several NGOs promote mediation in Ukraine with the assistance from the US and European donors and the World Bank, most active of them – Ukrainian Centre for Common Ground <http://uccg.org.ua> and Ukrainian Mediation Centre <http://ukrmediation.com.ua>. In 2010 after two years of drafting and lobbying efforts the first draft law on mediation was overturned by Ukrainian Parliament in the first hearing. By May 2012 the second, alternative draft was registered in the Parliament.

⁶⁹ The Law of Ukraine No 2711-IV ‘On *Treteyskiy Sud* (Domestic Arbitration)’ of 11 May 2004 <http://zakon.rada.gov.ua>

been in force in Ukraine since 2004, domestic arbitral institutions were reported to have a low demand and to have developed a negative image.⁷⁰

Finally, in contrast to Russian business (Volkov 2002, Gans-Morse 2011), the criminal enforcement of contracts through protection agencies or other criminal organizations was claimed not to be used by researched companies and was largely negligible in contemporary Ukrainian business.

Pretenziya

The successful survival of the Soviet legal institution of the pre-trial claim – *pretenziya* – in the contemporary market economy is by itself a notable specific of Ukrainian contractual relations. *Pretenziya* as an exchange of formal claims written under a certain template that preceded filing the lawsuit in courts, was found to constitute a fairly autonomous contract enforcement mechanism. It was treated by businesses as the threat of court action, yet also exhibited other non-legal functions. Around half of *pretenziyas* studied in this research were used in creative fashion in disputes with petty amounts of claim or in respect to uncontested matters. In these cases, *pretenziya* served as a tool to formalize a relationship, as a communication device, mediation technique, or bargaining leverage. These extra-legal functions of *pretenziya* illuminated its mixed nature. *Pretenziya* was capable of operating both as a token of the public order – the ‘shadow of the law’ – and as part of a private contract enforcement. Because *pretenziyas* were creatively embedded in private bilateral dispute resolution, they survived and remain in widespread use, despite the fact that this is no longer a pre-condition of a lawsuit.

⁷⁰ A few large banks and industrial groups were reported by the interviewees in this study to have been insisting on contractual arbitration clauses to submit future disputes to ‘the pocket arbitral tribunals’ under various trade associations created by them. For example, Third-Party Arbitration Court under Regional Law Group was reported by the interviewees to be associated with oligarch Rinat Ahmetov <http://www.rpgua.com>; Third-party Arbitration Court under Ukrainian Association of Producers of Ferrous Metals with oligarch Igor Kolomoyskiy www.ukrfa.org.ua

Commercial Courts

Although actually used in less than 1% of transactions of the researched companies, the role of courts in Ukrainian business was not insignificant. Within the contractual pattern identified by this study, courts were found to be generally capable of enforcing contracts. Notwithstanding their mostly passive role as a machine to rubber-stamp uncontested matters, commercial courts notably contributed to contractual compliance through their deterring role as the ‘shadow of the law’.

Ukrainian commercial courts were deemed functional by all the interviewees in this study and constituted a valuable backup for their private contractual arrangements in discrete and relational contracting alike. In practice, commercial courts indeed satisfied claimants’ demand for fair and quick compensation in most contractual disputes. Although it is admitted that most cases examined in this study were straightforward debt collections, statistics confirm that similar disputes make the most of the commercial courts’ caseload.⁷¹

Based on the findings of this research, proceedings in lower commercial courts from the day of filing to the date of the final judgment took on average 80 days and four hearings. Judgments were rarely appealed, and enforcement – either voluntary or through the State Enforcement Service – took on average 66 days. Thus the total duration of court procedures in Ukrainian commercial courts did not exceed 146 days, which was at least half the average duration documented by international surveys for Eastern Europe (Djankov *et al.* 2003).

The costs of court proceedings, including enforcement, were regarded by the interviewees as acceptable. The court fees in analyzed cases slightly exceeded 1% of the

⁷¹ <http://www.scourt.gov.ua>

claim. In all except one case, the researched companies did not hire outside counsel and were able to represent themselves, thus eliminating most of the costs of litigation.

Finally, although the enforcement of court decisions still left much to be desired, this research documents that 62.5% of judgments were enforced in full in less than two months of the final judgment, which runs counter to the generally assumed view of the ‘failure’ of the enforcement system in Ukraine (Vlasov 2007, Shevchenko 2009).

Thus this study suggests that the dysfunctionality of Ukrainian courts may be exaggerated. At least two thirds of court cases examined in this study went through the court system without any problem, ubiquitous corruption did not touch them, the thought ‘to bribe or not to bribe’ has not even occurred to the parties, court procedures were affordable and quick, enforcement of judgment almost automatic. At the same time, this study reveals that commercial courts played a specific role, very different from the developed countries, in assuring contractual compliance in Ukrainian business owing to their dualism, discussed in the following section.

The Dualism of Contract Enforcement

Although this study demonstrated that the majority of contracts were nearly perfectly enforced within a well-functioning system of private ordering supported by commercial courts, a minority of business relationships, primarily those involving the state in various capacities, were far more problematic for private Ukrainian businesses. State involvement as a false mirror distorted the operation of contract enforcement mechanisms in these few relationships. The findings of this research provide ample grounds to support Hendley’s argument of dualism of the post-Soviet courts, understood as operation ‘according to the law’ but with ‘an acceptance of outside interference’ (Hendley 2010a, p. 671) and to extend its logic to private contract enforcement.

The possibility of diverting public resources for private gain and to manipulate business relations through state machinery broke the observed contractual pattern of Ukrainian business into two parts. One part – mundane – embraced the majority of contractual relations that were summarized above, and the other – red-button relationships – involved the state and its administrative recourses in various forms. Although the incidence of the red-button contractual relationships as compared with overall numbers was relatively small, these relationships were particularly troublesome for businesses. Red-button contractual relations were at greater ‘risk’ of contractual defaults and eventually of litigation. While they comprised around 6% of contractual relationships, they gave rise to more than 20% of the court cases and to 67% of unenforced judgments.

The red-button contract enforcement practices were noticeable first of all in relationships with state-owned companies. These relations were seen by the researched private businesses as an opportunity to collectively extract rents from the state. Promising profits from contracts with state-owned enterprises were, however, undermined by enforcement problems. Given inferior managerial discipline, the short term office of executive directors, budgetary shortfalls and the impracticality of court recourse, private counterparties had to rely upon an illegal mechanism of kickbacks from suppliers (*otkat*) and to back up these illegal practices by Soviet-style personalized ‘sauna and vodka-drinking’ interactions.

Exceptional means of contract enforcement, which differed from ‘normal’ ones, became evident also in business relationships with the state agencies and with a few ‘muddy’ private companies which possessed informal links to local government. These relationships were dominated by the threat of administrative resources – the use of informal links to instigate inspections by taxation inspectorates and other state agencies imposing

outrageous fines on businesses. The threat was invoked to pressurize private businesses to terminate business relationships with certain trading partners, to transact with state agencies and ‘muddy’ private companies, to accept their unfavourable contractual terms, and to tolerate their contractual defaults. When the threat did not work out, administrative resources were used to attack the property rights of private businesses and to suppress their disobedience through law-enforcement agencies and the coercive use of the judiciary.

If the case went to court, all the state agencies and ‘muddy’ companies were reported to have seized an opportunity of employing their informal links to local government in order to produce the ‘desired’ content of judgment, to delay the court proceedings or to resist the enforcement of the judgment. Moreover, this study also demonstrated that it was possible for those who had not previously resorted to this to buy one-time access to administrative resources in courts.

The efficiency of commercial courts in the red-button cases was expectedly lower than in mundane cases. Red-button cases were considered by courts on average within 82 days, compared to 56 days in mundane litigation. Claims in the red-button cases were more likely to dispute law and facts of contractual performance. Judgements in red-button cases were more frequently appealed and proceedings entailed extra costs for parties to finance external legal advisors.

Additionally this study documents the increasing attractiveness of administrative resources to resist the enforcement of judgments made by Ukrainian commercial courts. It demonstrated that judgments in all cases involving state or ‘muddy’ private companies remained entirely unenforced. All the state-owned enterprises relied upon a statutory ban of seizure of state property and did not need to activate their administrative resources. In other cases, respondents did actively invoke administrative resources; as a result the State

Enforcement Service was found unable and unwilling to defy the pressure aimed at shunning the enforcement. This study documents that dualism affected the Ukrainian State Enforcement Service to even a greater degree than commercial courts.

Thus effective private and public contract enforcement was highly probable in Ukrainian business, but not completely assured owing to its dual nature, which entailed serious negative implications for business and society as a whole.

Administrative resources, although rarely employed in business-to-business relationships, polluted mundane contract enforcement. For example, the practice of kickbacks from suppliers, having initially originated in the state sector, spread epidemically within private companies through a negative learning effect and became one of the major problems there.

The persistence of distorted contract enforcement impeded the trust-building and norm-creation processes within business networks. This study documented the emergence of a trustful business environment which was nevertheless very unstable and shaky. All the researched companies invested effort into sustaining their 'honest' image but all conceded that if the survival of the company would be at stake they would cheat their trading partners. In a similar vein, all three companies claimed to have never paid bribes in commercial courts. Yet they reported that they would bribe the judge if 'required', albeit it was 'disgusting' for them.

The mere possibility of distortion in the contract enforcement system increased the general uncertainty of business environment. The unpredictability of the behaviour of state-owned enterprises and administrative resources holders in business-to-business relations prompted small companies to avoid transactions with them all together and increased the ultimate transactional costs of those who still did. In the same way, although business

people were fairly certain that judges in straightforward buyer-supplier disputes were not corruptible, nobody was completely sure about this. Some judges were seen as more prone to corruption than others. The uncertainty about the susceptibility of certain judges to bribes and administrative pressure was reported to induce some less risk-averse litigants to pay the bribe in order to prevent the other side themselves from bribing.

Finally, the dual nature of the Ukrainian judiciary seems to keep complex cases out of courts and thereby impede the mobilization of law by businesses. Where the facts of the dispute were messy and the law was contradictory or non-existing, it was believed to open up the possibility for manipulations of justice. Therefore it was safer to avoid the litigation of complex disputes in commercial courts. For example, the Farm Owner decided not to sue his supplier in the Newholland Combine Case (No 2.6, Appendix 3), partly because the dispute presented a novel and ambiguous legal matter.

Thus, although exceptional, flaws in private contract enforcement and distortions in the delivery of justice remained inbuilt within the dualistic system. Viewed in the context of the wider business environment, they produced a disruptive effect on the contractual relations of Ukrainian businesses.

The above ideas conveyed in response to the series of questions set forth in this study have enlightened existing research on contract enforcement in several ways. This study contributed into the empirical part of contract enforcement literature by offering the first relatively integrated account of daily contractual practices in contemporary Ukraine. It encompassed buyers' and sellers' perspectives, business relations between first-time and regular trading partners involving private and state-owned companies of various

organizational structures. The study concentrated on the contractual pattern prevalent in low technology moderately competitive industries in Ukraine. At the same time, given the highly qualitative methodology of this research, it is acknowledged that the other patterns may occur in Ukraine's innovative or highly competitive industries which require further research.

This study adds a theoretical value to existing literature on contractual relations in business in three directions. First, the findings of this study supported the need to differentiate between contract enforcement in relations with first-time trading partners (discrete contracting) and with regular trading partners (relational contracting). These contracting modes were shown to determine the choice of specific contract enforcement mechanisms and the way these mechanisms operate, complement or substitute one another. This study also found that some contract enforcement mechanisms, namely self-enforcing devices, are qualitatively different for protecting buyers (prepayment) and sellers (quality assurance). Furthermore, the same mechanisms were demonstrated to play differently for enforcing payment and quality promises. Therefore, inquiries into contract enforcement practices in any societal settings are better served by differentiating between discrete and relational contracting, and between buyers' and seller's mechanisms.

Second, this study contributed to the recognition of the paramount importance of the wider business environment in shaping the contract enforcement practices of businesses. In light of the debate about whether contract enforcement institutions cause economic growth or develop as its consequence (Glaeser *et al.* 2004, Trebilcock and Leng 2006, p. 1565), this research concludes that the observed contractual pattern evolved in Ukraine largely as a response to the adverse impact of the transitional business environment. It is likely that standalone attempts by the Ukrainian government, foreign

donors or the business community to improve selected contract enforcement mechanisms, such as for example the reform of court case management or the development of business associations, are likely to remain at best futile until the wider business environment is changed.

Third theoretical contribution of this study refers to the specific role played by the state in shaping post-Soviet contract enforcement. Among all the factors of the business environment in Ukraine, the predatory role of the state was revealed by this study to be the key factor contributing to high uncertainties, low technology development, restricted market competition and the dualism of contract enforcement, thereby constraining the development of contractual relations in Ukraine.

As demonstrated by the increasing number of studies, the development of the market economy in contemporary circumstances requires higher investment in specialized skills and assets, the diversification of production lines, deeper interdependency between trading partners, support by multilateral third-party reputational institutions, and by courts capable of dealing with complex cases (Nunn 2007, Greif 2008, Gilson *et al.* 2009, Dietz 2012). These changes require ‘credible restrictions on the state’s ability to manipulate economic rules to the advantage of itself and its constituents’ (North and Weingast 1989, p. 808). As shown by Greif when it is not the case, ‘markets are confined to the exchanges that are possible based on private-order, contract-enforcement institutions that are more successful in mitigating the threat posed by coercive power’ (Greif 2008, p. 777).

This study concludes that without institutions to constrain rent seeking and eliminate dualism in contract enforcement, Ukrainian businesses will not invest into long-term innovation projects in the first place, and will continue to trade under the safer option of the quasi-spot market. When neither a technological breakthrough nor substantial

improvements in the banking system are feasible, contract enforcement in Ukraine will remain within bilateral confines largely effective yet tailored to technologically underdeveloped business relations stuck half way between North's simple and complex economies (North 1990, p. 56-60).

APPENDIX 1 THE LIST OF INTERVIEWEES

THE PLANT

Dates of Interviews	Position of the Interviewee within the Company	Sex	Years in the Company
06.09.2007	Director General	M	7
13.08.2008	Chief Accountant	F	8
10.12.2009	Vice-Director for Marketing	M	8
17.07.2007	Vice-Director for Sales	M	10
28.10.2008	Vice-Director for Supplies	M	11
19.11.2008 27.11.2008 10.12.2009	Vice-Director for Economic Security A	M	17-18
19.11.2008 10.12.2009	Assistant to the Vice-Director for Economic Security A	M	3-4
03.11.2010 23.12.2010	Vice-Director for Economic Security B	M	1
03.11.2010 23.12.2010	Assistant to the Vice-Director for Economic Security B	M	2
01.11.2011	Head of the Technical Quality Department	F	7
17.07.2007 26.07.2007 03.08.2007 13.08.2007 06.09.2007 06.11.2008 19.11.2008 05.11.2009 09.11.2009 02.12.2009 16.12.2009 28.12.2009 29.10.2010 21.12. 2010 23.12. 2010 11.10. 2011 18.10. 2011 27.12. 2011	Head of the Legal Department	F	5-10
24.11.2009 25.11.2009 29.10.2010 23.12. 2010 11.10. 2011 18.10. 2011	Lawyer	F	2-5
28.10.2008	Head of the Supply Department	M	5

7.11.2008			
31.10.2008	Supply Manager	M	2
06.09.2007	Assistant to the Head of the Supply Department	M	2
26.07.2007	Head of the Sales Department	M	7
12.11.2008 08.12.2009 13.12.2010	Sales Manager A	M	1-3
01.08.2007 03.09.2007 13.12.2010	Sales Manager B	M	15-19
01.08.2007 03.09.2007 12.11.2008 10.12.2009 5.11.2010 13.12.2010	Sales Manager C	M	6-10
12.11.2008 10.12.2009	Sales Manager D	M	5-6

THE PLANT'S TRADING PARTNERS

Dates of Interviews	Position of the Interviewee within the Company	Sex	Years in the Company
27.07.2007	Top Manager of the Construction Company (BUYER)	M	4
19.10.2011	Manager of the Cable Trading Company (BUYER)	M	2
11.09.2008	Lawyer of the Construction Materials Factory (BUYER)	F	1
07.09.2007	Head of the Legal Department, Industrial Holding (BUYER)	M	10
01.08.2007	Sales Manager of the Metal Trading Company (BUYER)		2
13.10.2011	Owner of the Small Innovation Firm (SUPPLIER)	M	12

THE FARM

Dates of Interviews	Position of the Interviewee within the Company	Sex	Years in the Company
02.04.2007 09.07.2007 11.07.2007 17.07.2007 26.07.2007 01.08.2007 13.08.2007 04.09.2007 17.10.2008 08.12.2008 23.12.2008 15.01.2009 02.12.2009 07.12.2009 09.12.2010 25.12. 2010 07.09.2011 23.12.2011 26.12.2011	Farm Owner	M	7-11
04.11.2009 20.11.2009 08.12.2009 28.12.2009 15.12.2010 20.10.2011	Farm Manager	M	7-11
17.09.2008	Chief Agronomist	F	20
17.09.2008	On-site Manager	M	5

THE FARM'S TRADING PARTNERS

Dates of Interviews	Position of the Interviewee within the Company	Sex	Years in the Company
24.07.2007	Sales Representative of the Agri-Machines' Trading Company (SUPPLIER)	M	8
03.08.2007	Top Manager of the Trucking Agency (SUPPLIER)	M	9
10.09.2007	Father of the Farm Owner, Co-owner of the Dairy and two Farms (BUYER/SUPPLIER)	M	16
15.12.2010	Vice-Director of the Pizza Bakery (BUYER)	M	4

THE CAFÉ

Dates of Interviews	Position of the Interviewee within the Company	Sex	Years in the Company
07.10.2008 18.10.2008 04.11.2008 03.12.2008 20.10.2009 24.12.2009 09.12.2010 28.12.2010 07.09.2011	Café Owner	F	13-16
08.12.2008 10.12.2009	Salesman A	F	8-9
02.11.2009	Salesman B	M	3
09.11.2009 10.12.2010 26.10.2011	Salesman C	M	3-5
03.11.2009 04.12.2009 09.12.2010	Salesman D	F	11-12

THE CAFÉ'S TRADING PARTNERS

Dates of Interviews	Position of Interviewee within the Company	Sex	Years in the Company
28.10.2011	Sales Manager of the Food Trading Company (SUPPLIER)	M	2
20.12.2010 16.08.2011	Sales Manager of the Bakery (SUPPLIER)	M	2

**APPENDIX 2 BACKGROUND INFORMATION ON THE RESEARCHED
COMPANIES**

	The PLANT	The FARM	The Café
Size (number of employees)	552 in 2007, 495 in 2010	58	5
Sectors of economy	Industrial manufacturing	Agriculture	Retail trade and restaurant service
Market size	Ukraine and CIS	Donetsk region	City district within Donetsk
Founded in	1962	2000	1995
Corporate structure	Open joint-stock company	Limited liability company	Self-employed
Profits from sales in 2007 (UAH)	240,000,000	10,000,000	80,000
Number of buyers and suppliers in 2007	500	122	24
Number of buyers and suppliers in 2009	400	92	23
Lawyers or legally trained personnel	Legal Department of two lawyers. One of the two CEOs had a law degree	The Owner had a law degree	The Owner had experience of self-representation in commercial courts

Transactions of the Researched Companies

	Plant	Farm	Café
Sales	industrial cable	wheat, corn, malt, millet, sun-flower seeds	snacks and beverages (directly to consumers)
	industrial waste	harvesting services for other farms	-----
Supplies	machines, copper, plastic, chemicals, etc	machines, petrol and oil, seeds, chemicals	snacks and beverages (non-alcoholic and beer)
	spare parts, office supplies other materials unconnected to production	spare parts, office supplies, other materials unconnected to production	minor trading equipment
	----	office rent	land rent, trading space rent, rent of trading equipment
	banking and consulting services, advertisement	banking and consulting services	----
	transportation, repair of vehicles	transportation, repair of vehicles	----
	land-line and mobile telephone services	land-line and mobile telephone services	---- (use personal mobile phones)

Number of Transactions, Contract-Breaches, Pre-Trial Claims (*Pretenziya*), and Court Cases of the Researched Companies

	Years	Transactions under written contracts	Contract-breaches	<i>Pretenziya</i>	Court cases
Plant (Sales)	2008	1680	168	8	1
	2009	480	24	5	2
Farm (Sales and Supplies)	2008	312	34	1	0
	2009	252	44	0	0
Café (Supplies)	2008	850	6	1	1
	2009	725	3	0	0
TOTAL for three companies	2008 and 2009	4299	279	15	4

APPENDIX 3 CASES AND RELATIONSHIPS OF THE RESEARCHED

COMPANIES

1. The Plant

1.1. ABZ

ABZ was a private construction company contracted by the Plant to install roads in and around the Plant's premises. As claimed by the interviewees, the relationship apparently involved kickbacks from suppliers and informal agreements between the directors. After the general director left the Plant in November 2008, the relationship soured. As a result, ABZ terminated the contract leaving behind some work unfinished. Besides, the Plant sold ABZ some unwanted bitumen at a discounted price which ABZ never paid for. After two months of unsuccessful negotiations the case was transferred from the supply department to the Plant's lawyers who drafted and dispatched the pre-trial claim (*pretenziya*). In January 2009 the Plant filed a lawsuit with the commercial court. ABZ did not show up at the court hearings and both judgments were made by default in favour of the Plant in March 2009.

The judgments were ignored by ABZ and the Plant initiated an enforcement procedure with the State Enforcement Service (SES) in May 2009. After two months of inaction by the SES, the Plant complained to the Prosecutor's office which did not produce any result. When it became obvious that 'there is something wrong', the Plant's Vice-Director for Economic Security conducted a private investigation and discovered that the debtor was protected by the roof (*krysha*) of the Security Service of Ukraine – one of the powerful state agencies, the former KGB. The Security Service apparently communicated to the SES the 'undesirability' of enforcement against ABZ. Eventually, after almost two years of enforcement efforts, the Plant was able to settle with ABZ for an in kind

contribution. Since February 2011, ABZ began to supply the construction materials to the Plant in small bits to offset the court decision made in April 2009.

1.2. Dneprovskiy Plant

In 2006 one of the regular customers, the Dneprovskiy Plant, did not return cable drums which it undertook to do so under contract. However, it was the Plant itself that did not send a written request to the debtor to return the drums; correspondingly the debtor did not initiate the transfer. The exact reason for the court action remained unclear. Apparently there was some personal misunderstanding involved. The Plant waited three years and eventually sued Dneprovskiy in 2010 just when the period of limitation was about to expire. Yet the Plant lacked the documents to prove in court its right to get the drums back, and the court dismissed the Plant's claim. In 2011 the Plant initiated a new contract with Dneprovskiy.

1.3. DUEK

DUEK was an alliance of state-owned coalmines and related enterprises which the Plant used to supply cable to since the Soviet times. Cooperation with DUEK was always uneven. Sometimes the Plant requested only prepayment, at other times it was possible to establish informal relations with the ever-changing DUEK directors, as claimed by the interviewees, based on kickbacks from suppliers. In the end of 2008, the executive directors of both enterprises – DUEK and the Plant – were changed and DUEK continued to owe a large amount to the Plant. The Plant sued DUEK in October 2009. During the court hearing, the DUEK lawyer recognized the debt but tried to argue for penalties. The attempt was seen as clearly doomed to failure and the judge awarded the Plant the full amount of debt and penalties claimed. By January 2012 the judgment remained unenforced

due to the statutory ban at the seizure of the state property. The Plant had not renewed trading with DUEK owing to the persistent liquidity crisis of the latter.

1.4. Initskiy Plant

Initskiy was a privatized machine-building enterprise founded in Soviet times and one of the oldest clients of the Plant. In the mid-1960s in accordance with the Soviet plan the Plant modified technical characteristics of one specific type of its cable to suit the needs of Initskiy. Since that time Initskiy was tied to the Plant despite being located miles away – in the West of Ukraine. Jokes about this customer had been made at the Plant for generations. According to the young sales manager who was not yet born at that time, the Gosplan (The Soviet Agency of Planning) once messed up the quantity of cable to be produced for Initskiy and the latter refused to accept extra cable. As nobody else was eager to buy customized cable, it rotted and was eventually disposed of by the Plant a decade ago.

Since privatization, Initskiy was constantly under threat of illiquidity and caused the Plant minor but continuous problems. The Plant tried to trade with Initskiy under prepayment contract terms. When Initskiy was at times able to elicit trade credit, it always resulted in a payment delay. Additionally, in order to save on payments to the Plant, Initskiy often refused to pay for the ‘tolerance’ (extra unordered cable). During the five years of this research, Initskiy received three pre-trial claims (*pretenziya*) from the Plant yet eventually paid under all of them, thereby avoiding court action.

1.5. Congo Rubber

In 2008, the Plant contracted a Ukrainian supplier of imported rubber who undertook to deliver rubber produced in Indonesia. However, upon delivery it was discovered that the rubber supplied was produced in Congo. The Plant took the risk and put the Congo rubber into production, but it did not pay off as the output cable was of substandard quality. The representatives of the supplier arrived at the Plant and confirmed the deficient quality of the supplied rubber by signing an Act of Deficiencies in accordance with the P6 and P7 Instruction on Inspection of the Goods. The P6 and P7 Instructions regulated the quality inspection of the input before they were put into production, therefore both parties agreed to antedate the Act as if it had been signed right after delivery. Pursuant to the Act, the Legal Department of the Plant initiated a pre-trial claim (*pretenziya*) which allowed the supplier to take the remaining rubber back. No damages were claimed by the Plant as they perceived the problem to be their own fault. However, the business relationship with this supplier was terminated and not renewed, at least not before the completion of this study.

1.6. Lost Truck

In 2001 the truck belonging to the carrier contracted by the Plant, disappeared in transit with a cargo of cable. Later, the documents were discovered to have been forged by the driver while the management of the carrier claimed to be unaware of the forgery. The Plant won the case in commercial court against the trucking company, and the latter paid the damages in full, but brought criminal charges against the driver seeking restitution.

1.7. Rovenki

Rovenki was an alliance of state-owned coalmining enterprises comprising six mines, three coal processing plants and a number of infrastructure enterprises. Rovenki had always to prepay their contracts with the Plant. Only after Rovenki received money from the central budget did they order the cable. In 2008 one of the oligarchs, the biggest client of the Plant, was about to invest and manage Rovenki. Therefore the Plant in its efforts to beat competitors took its chance and delivered a big supply of cable to Rovenki without prepayment, hoping that the oligarch would pay later. However, the investment contract did not work out. Given the liquidity crisis at the Plant and unclear prospects of the Rovenki privatization, the Plant sued it and obtained the judgment in November 2009.

The researcher was present at the only hearing in commercial court. While waiting in the corridor the respondent's lawyers announced that they admitted the debt and formally agreed to pay the debt and the penalties. The hearing took ten minutes for the judge to confirm this agreement. By January 2012, the judgment remained unenforced owing to the statutory ban and the seizure of the state property. Nevertheless the Plant continued to trade with Rovenki under prepayment contract terms.

1.8. YuGOK

YuGOK, a private coal refining enterprise, was hit by a corporate raid in 2009-2010. While several court actions were in progress, two teams of managers competed for control over the company which inevitably caused chaos in its payments.

The relationship with YuGOK was apparently of high value to the Plant, which was confirmed by the efforts invested in negotiations. After the Plant's sales managers declared

their inability to secure payment, the Plant's lawyers had to talk to YuGOK's lawyers. The lawyers did not object to the fact of the debt, but blamed organizational confusion and referred the Plant to the financial directors. In order to reach them, the Plant's lawyer had to pretend to be a financial director of the Plant, yet she failed to receive any definite assurance of repayment. The Plant filed a lawsuit in commercial court in April 2008 while still continuing negotiations. Eventually the case was settled out of court. The debtor agreed to pay the full debt and court fees, and the Plant waived the penalties for late payment. Although the Plant's lawyers insisted on the penalties, their sales managers persuaded them to forgive them for the sake of a continuing business relationship, which was indeed renewed in 2010.

2. The Farm

2.1. Don Combine

In 2003, the Farm bought the combine produced by an ex-Soviet Plant in Russia through a small distributor company in Donetsk. The combine was broken in the summer of 2004, and pursuant to the contract the seller repaired it twice but disappeared when it had broken for the third time. The Farm needed the combine urgently to complete harvesting. Therefore, the Farm's mechanics bought a new engine and installed it by themselves. The Farm Owner drafted and dispatched a pre-trial claim (*pretenziya*) requesting damages, but the seller never answered it. In 2004, the Farm Owner filed a lawsuit against the seller who appeared only at the first court hearing and missed two others. The judgment was made in favour of the Farm, which was awarded the direct damages but not the lost profit. As suspected by the Farm Owner, the respondent apparently bribed the judge to protract court procedures to almost six months to allow time for asset stripping. Consequently, the judgment was never enforced as the debtor went into bankruptcy. The business relationship was terminated.

2.2. Elevator Rodnik

Elevator Rodnik was located very close to the Farm's fields. However, the Farm avoided using their services and instead regularly stored its yield at a more distant grain elevator. As the Farm Owner explained, the problem was that 'they were rotten (*gniloy*) people at Rodnik' and the Farm has always had conflict with them. The staff turnover at the elevator was high, and the attitude to the clients was far from friendly.

According to the Farm Owner, Rodnik apparently maintained a ‘roof’ (*krysha*) with local authorities, as they were always designated for state procurement contracts. If a private company wished to sell to the state, it was obliged to store its grain at Rodnik. In 2009, the Farm was selling to the state-owned company and stored its wheat at Rodnik. Despite official documents from the State Bread Inspection certifying the Farm’s wheat to be stored as 3rd class, Rodnik downgraded the quality to 4th class and unilaterally decreased its price. As the deal was still profitable to the Farm even with the downgraded wheat, conflict was avoided, although the Farm Owner claimed to have told Rodnik managers ‘everything that he thought of them’. Yet the Farm realistically was prepared to work again with Rodnik if required for state procurement contracts.

2.3. *Kaskad*

Kaskad was a ‘conditionally blacklisted’ customer of the Farm which caused regular payment delays and other minor problems, but was still contracted by the Farm when profit considerations required it. In autumn 2009, the Farm discovered that its corn stock was deteriorating and they urgently needed to sell it. Kaskad agreed to buy corn of a substandard quality, but expectedly delayed the payment. While Kaskad struggled to pay for the supply of corn in small installments, within one month the Farm found itself short of cash. According to the Farm Manager, Kaskad understood the Farm’s problems ‘humanly’ (*po-chelovecheski*) and promptly transferred the last installment to the Farm.

In December 2010, during another delivery of corn to Kaskad, its workers damaged the Farm’s truck with their loader. The Farm was able to negotiate the repair of the truck and Kaskad agreed to cover the costs of the repair, according to the Farm Owner, owing to the long-standing relations between the parties.

2.4. Makeyevka Mill

In summer 2008, the Owner's Farm rendered harvesting services to an unfamiliar first-time trading partner – Makeyevka Mill located some 200 kilometres away. The request for harvesting services was obtained through the Rayon Administration (the local government agency) that served as a clearinghouse for farmers. The Owner did not screen the Mill and signed two contracts amounting to UAH 100,000 (US\$ 10,000), both containing trade credit. The Farm Owner explained that it was pointless to request prepayment from the Mill in the middle of harvesting season, when they obviously did not have cash at hand. The Mill paid on the first contract but defaulted on the second one. In a month or so, the Owner learnt from the employees of the Mill that its founders were in conflict and the Mill was close to bankruptcy. In this situation the Owner was contemplating using a pre-trial claim (*pretenziya*), but this was never dispatched or even drafted. A few inquiries by the Owner about the financial situation of the Farm in 2009 did not prompt any action; the debt was deemed as irrecoverable and the business relationship was terminated. The Farm Owner was not keen to chase the debt because he still made some profit from the first contract.

The Mill officially went into bankruptcy in 2010, and by 2011 a new enterprise was set up with the same employees. The old debt was never repaid and the Farm refused to trade with the new enterprise.

2.5. Mariupol Farm

In the first year of its operation in 2003, the Farm borrowed 63 tons of barley seeds from the Mariupol Farm. The contract contained an obligation on the borrower to return the

same amount of seed or equivalent in cash in the autumn of 2003. The contract was fully negotiated by the Owner's father – a locally well-known businessman – based upon his personal links with the Chief Agronomist of Mariupol. The Farm Owner claimed to have simply forgotten about the deadline to repay the debt and did not contact anyone. The lawsuit in commercial court was therefore a surprise, initiated without any prior notice. According to the interviewees, the Mariupol lawyers, being unaware of the informal agreement and friendly relations between the parties, sued the Owner's Farm 'automatically'. While the court hearings were in progress the father and the Owner tried to negotiate the matter with the Agronomist but he could do nothing to stop the court action. As the Farm Owner sold all his barley yield and had nothing to return immediately, the Mariupol director was unprepared to settle. Only after the court judgment was made, did the parties agree that the Owner supply sunflower seeds to offset the debt. As a result, the business relationship was definitely terminated and the Owner reported to have learnt the lesson not to resort to his father's links in business-to-business relations.

2.6. Newholland Combine

In the summer of 2007, the Farm bought an expensive US-produced combine from a Ukrainian dealer located in the neighboring region of Dnepropetrovsk. The summer was exceptionally hot and dry in Ukraine. After four days of work, the combine began producing unacceptable losses of grain and was stopped until further investigation despite the urgent need for machines.

The Farm Owner sent a letter almost immediately to the supplier with a statement of losses and a claim to replace the combine. Four teams of the supplier's mechanics visited the site and examined the combine over the next three weeks.

The first examination resulted in a signed document stating that (1) the combine produced losses, (2) attempted tuning methods did not eliminate the losses, (3) in the morning when the grain was wet, the losses were within a normal level. The second examination confirmed the losses but cast doubts that the losses indeed exceeded the standard. The third examination by the supplier's head of the Service Department resulted in an official document stating 2-3 % of the losses (against 1% allowed by the standards). A fourth examination by the manufacturer's representatives finally confirmed that the combine was sound, but this particular model was not designed to deal with the over-dried grain.

Emotional tension increased dramatically by the third examination. The Farm Owner had a telephone conversation with the director of the supplier who refused to talk about compensation. A third examination was carried out under high pressure; it was filmed by video in the presence of local government officials and accompanied by oral threats of court action and damage to reputation.

Meanwhile, the Farm Owner backed himself up by written evidence. He drafted Acts of Expertise regarding dryness and the loss of grain. Although the Acts contained inflated figures, governmental officials charged with the technical supervision of local farmers readily signed them and ensured their support to the Owner.

Finally, the Farm Owner went in person to meet the director of the supplier in Dnepropetrovsk. The latter confessed that their combines did have the similar problem in Africa and Australia but never in Europe, thereby agreeing that that particular model was unsuited to over-dry harvesting conditions. Attempts to negotiate a settlement failed, as both parties found the settlement offers unacceptable. Ultimately the Farm Owner

threatened to go to court which would result, according to the Farm Owner, in the supplier's 'loss of the whole Donetsk region for their sales'.

Following an unsuccessful meeting, the Farm Owner sent the supplier a pre-trial claim (*pretenziya*) with a request to terminate the contract and pay damages. Only three weeks later did the supplier answer in writing, rejecting in full all the claims.

A few other attempts by the Farm Owner to modify the settlement offers through the supplier's local sales representative did not succeed. The combine was put back to work albeit on a lower speed and still producing losses. In the autumn the matter apparently was put aside. Prompted by favourable market conditions, the Farm Owner negotiated a new deal with the supplier. In December 2007, he bought a tractor and received a good discount from them. The parties met occasionally at the agricultural exhibition next year but displayed no open sign of hostility. However, the Farm Owner was still prepared to go to court if the problem of losses came out the following summer. Luckily it did not. The Farm continued to work with the Dnepropetrovsk supplier to service the machines bought previously, but switched to another supplier for new machines.

2.7. Urgent Purchase of Chemicals

On Friday December 4th 2009, a buyer who had taken samples of the wheat from the Farm called and warned that the wheat was infected. It was already Friday afternoon and the Farm Manager urgently began to telephone chemical suppliers. Eventually he found one supplier and they agreed on a price. According to the Farm Manager, five minutes later he had found a better deal at a closer location and called the first supplier to cancel the delivery. By that time the working day was over, and the Farm Manager had to go himself to pick up the chemical from the second supplier. When he arrived at their warehouse, he

found the box of required chemicals at the clock house. The Farm Manager had to hand the receipt to someone, and therefore waited for the guard to come out and take it. According to the Farm Manager, ‘this was stupid of them to leave the box unattended; these were us but someone else could have taken it and run off without leaving any documents’. The same evening the wheat was successfully disinfected.

2.8. Valdi

In the spring of 2005, in anticipation of a price rise for diesel fuel triggered by a governmental decree introducing a new tax, the Farm decided to quickly buy fuel at existing prices. A supplier was found in a rush, it was referred to by another trading partner of the Farm. The contract was promptly signed and the Farm paid the full price the same day. Next morning the prices went up. The seller refused to deliver and tried to negotiate a deal to deliver a lower quantity than agreed in the contract. The Farm Owner was on vacation and the seller negotiated with the Farm’s Manager in a very impolite manner. The Owner instructed his Manager to agree on a lower quantity, but was already prepared to sue the seller. No new contracts or papers were signed with regards to the agreed lower quantity of the supply. When the supply was delivered, the Farm was not happy with the quality of the fuel. After the Owner came back from vacation, he called the seller and asked for the remaining quantity to be delivered contrary to the oral agreement. The seller did not agree and the newly initiated relationship was completely soured.

Bypassing the stage of pre-trial claim, the Owner promptly initiated court action. Having a written contract at hand and being sure that the seller did not retain any written evidence of the oral modifications to the contract, the Farm Owner saw the case as successful. He explained that Ukrainian contract law required all contract modifications to

be done in the same form as the main contract – in writing. The Owner easily won the case in commercial court. The judgment demanded the seller pay compensation for unsupplied fuel and court filing fees. The seller appealed the judgment in the second instance, but lost. The Farm Owner reported that the appeal was obviously doomed to fail, but the seller felt offended and made its lawyer struggle through an appeal. Eventually, after the appeal failed, judgment was enforced promptly through the State Enforcement Service which arrested the bank accounts of the debtor. The relationship was terminated.

2.9. Volnovakha Poultry

Volnovakha Poultry was a long-standing but minor customer of the Farm. It often delayed payments for corn but never for longer than a week. In 2007, Volnovakha was bought by a company from Western Ukraine which resulted in far more prolonged delays, because all decisions were now made in Kyiv. Although Volnovakha did not formally owe the Farm it became obvious that they would default on contracts. The Volnovakha's director and the manager with whom the Farm used to work left the company, and the business relationship was seen as terminated. According to the Farm Manager, 'they almost died for us'.

3. The Café

3.1. Coca Cola, Day of Children

On Sunday 1st June 2008, the local State Administration organized festival for the Day of Children at the central square of Donetsk. The street leading to the square was blocked to cars. The Café Owner was contracted by the State Administration to serve drinks for the event. She explained to the Coca Cola manager that it was essential that the truck came in time before the street was blocked, but the truck came late. After it became clear that the trade agent was unable to do anything, the Café Owner called the senior manager of Donetsk Coca Cola and asked for help. The senior manager ordered fifteen Coca Cola employees to bring the drinks to the kiosk by hand. As a result, according to the Café Owner, she lost 50% of the expected profit. Yet the idea of claiming damages or contractual penalties for the delay did not occur to the Café Owner. Later she urged Coca Cola to replace the trade agent, but he was left in place and no problems arose with him anymore.

3.2. Coca Cola, Outdated Goods

At the end of August 2008, Coca Cola supplied outdated juice for the street festival that the Café Owner was serving. However, the weather on the day of the festival was rainy and the juice did not sell out. Instead, the Café Owner brought these juices to another park festival organized later by the private company. Then she noticed that the juices were outdated. She called her Coca Cola agent and they promptly replaced the juices the same day. The Café Owner reported to have experienced no losses in the result of the replacement and no claims were brought forward.

3.3. Kiosk

In 2010 the Café Owner was subjected to several inspections by the Prosecutor's Office and the Department of Land Resources demanding land permits and consequent contributions of land tax. The law required land permits for buildings, but the Owner's kiosk was operating in a tent that could be collapsed and removed any time. Therefore, the Café Owner first tried to persuade the inspectors by showing them the contract from her beer supplier that stated that the tent was 'removable marketing equipment'. When this did not help, she turned to her acquaintance in the City Council who was able to negotiate the matter with the Regional Land Committee. Eventually, while the neighboring kiosks were forced to leave, the Café Owner's kiosk remained in place.

3.4. Leisure Park

In 2007-2008 the Café Owner was involved in a protracted dispute with one of her landlords – the state-owned Leisure Park – regarding the rent of land under her Café. The dispute began as a disagreement between the Owner and the Director of the Leisure Park as to the renewal of the rent contract. According to the Café Owner, the Director of the Leisure Park was unhappy about her renting land in the Park, and wanted his daughter to have this plot instead. From the very beginning, the problems were communicated between the parties through written letters. The Park Director claimed that the Café Owner systematically left out garbage, did not properly maintain her premises, polluted the river with food remains, and did not obtain all necessary documents from the state organs to do her business. When the level of antagonism increased, the Director of the Leisure Park switched to the strategy of 'ordered inspections'. He organized inspections by the tax, fire,

sanitation and occupational safety inspectorates and the local Prosecutor's Office, which imposed outrageous fines on the Café. Ultimately, inspections identified that the Café lacked a land permit. In 2007, the Prosecutor filed a lawsuit in a commercial court to evict the Café Owner.

The law on this issue, namely the Land and the Commercial Codes of Ukraine, was highly contradictory and unclear – one Code prescribed businessmen to obtain permits, the other did not. This allowed the Café Owner to succeed in protecting her rights in the commercial court of the first instance, and the judge dismissed the Prosecutor's claim. The Prosecutor appealed, but this failed. In the autumn of 2007, the Café Owner, perhaps inspired by her victory, initiated a new lawsuit against the Park to force the Director to renew the contract with her or to provide a replacement. In 2008, she lost her case in the lower and in the appellate commercial courts.

In both commercial lawsuits, the Café Owner was able to represent herself. Although in the beginning she hired a lawyer from a city law firm, she was greatly dissatisfied by the quality of the services and decided to go on without a lawyer, relying on her personal connections with a few practicing lawyers.

At the beginning of 2008, the Prosecutor brought criminal charges against the Café Owner, the Café Owner suspects in revenge for her lawsuits. A charge was fabricated that the Café Owner illegally employed a minor in her Café. The 'victim' of this alleged crime was a seventeen-year-old homeless boy with two criminal convictions for robbery, who was at that time in custody in for another investigation for a third robbery. The trial took fourteen months and seven hearings. During this time, the Café Owner was not allowed to leave Donetsk. The fees that she has paid to her attorney amounted to more than UAH

10,000. Yet no costs could compare to emotional pain that the Café Owner and her family suffered this year. Eventually the charges were dropped ‘for a lack of evidence’.

To the credit of the Café Owner, she managed to survive criminal prosecution, and later continued and even expanded her business. In the aftermath of these events, she did not regret having messed up with the state. She concluded: ‘I went out of it with my head up’.

3.5. Red Bull

The Café Owner successfully served a few promotional events through the beverage company Red Bull in Donetsk. Another large company – the mobile telecom provider Kiev Star – decided to organize a festival at the Leisure Park for children and families. The employees of Kiev Star came to the Café Owner when she was serving the Red Bull event and asked whether she could do it for their festival. However, when the Café Owner contacted Kiev Star to arrange the contract, they replied that their boss in Kiev had found someone else. The Café Owner was upset, but a day later they called back and asked about the exact name of the Café Owner’s business. It turned out that two Kiev managers communicated her name to each other in Kiev. She was proud to be known for excellent services even in Kiev, and eagerly accepted the offer.

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