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SUPPLY AND DEMAND FOR CONTRACT ENFORCEMENT IN RUSSIA: COURTS, ARBITRATION, AND PRIVATE ENFORCEMENT[1]

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1. Introduction

Market transactions take place throughout the world, for the most part, without recourse to either explicit legal rules in the form of statutes or case law or law enforcement institutions. Historical examples, cross-cultural analyses, as well as empirical evidence from developed market economies evidence that these legal institutions provide but a fall back position. In the majority of cases, parties either do not need to enforce contracts because breaches have not occurred, litigation was deemed to exceed the costs of its benefits, or parties use "nonlegal sanctions"[2] based on reputation rather than on legally-enforceable rights.[3] One may therefore question the importance of state courts for contract enforcement. Apparently, private parties are quite capable of conducting the majority of their business transactions outside the court system. In addition, private parties largely transact without much attention paid to written statutes or detailed contractual provisions.[4] The "battle of the form" problem – with which courts are confronted once these contracts are litigated – is ample evidence of the fact that many business people ignore the fine print of standardized contracts.

1. I am indebted to the CEU Privatization Project for financial support for the research presented in this paper.
2. See David Charny, "Nonlegal Sanctions in Commercial Relationships", 104 *Harvard Law Review* 1990, 373. Charny defines nonlegal sanctions as "commitments that are *not* legally enforceable as formal contracts", *ibid.*, 379.
3. See also Marc Galanter and Joel Rogers, "A Transformation of American Business Disputing? Some Preliminary Observations", *Working Paper Dispute Processing Research Program (DPRP)* No.10-3, University of Wisconsin, 1990. Despite the fact that the authors document a significant rise in "business versus business litigation", they still concede that "only a small fraction of all disputes are litigated. Far more common is resolution of differences by negotiation, compromise, exit from the relationship giving rise to the dispute, or informal sanction of the party violating the terms of that relations", *ibid.*, 35.
4. See Stewart MacAulay, "Non-Contractual Relations in Business", 28 *American Sociological Review* 1963, 55, whose study revealed that few businessmen pay attention to the fine print of contracts and call in lawyers only after mutual agreements have failed.

This raises a fundamental question about the function of state-provided institutions for economic activities. Transaction cost economics offers some explanation for the function of state-provided courts and legal rules: unlike most private arrangements, courts offer coercive contract enforcement that helps private parties to engage in transactions outside a social network that would allow close monitoring of current and potential business partners.[5] A standard set of rules reduces the costs of individual contracts, because many terms do not have to be negotiated, as they are provided by formal legal rules.[6] Finally, to the extent court procedures and coercive enforcement are effective, these institutions function as a recourse of last resort and thereby provide a deterrent against breach of contract.[7]

Most of these theoretical propositions have remained empirically untested. The general hypothesis that with economic development the complexity of commercial transactions increases which, in turn, leads to an increase in litigated cases, has found only weak confirmation in cross-country longitudinal studies on civil litigation.[8] Apart from methodological problems[9] and the lack of well-grounded theories,[10] a main problem of studies that rely only on litigation data is that they do not control for the quality of courts and the services they offer, or for alternative mechanisms that private parties may develop over time to reduce the costs of doing business in a complex environment. For a better understanding of the role of courts, it is important to understand the relative costs of court and out-of court enforcement of contracts given the prevailing economic and institutional environment for business.

5. Oliver Williamson, *The Economic Institutions of Capitalism*, New York, 1985, Chapter 1, especially p. 28; Paul R. Milgrom, Douglas C. North, and Barry W. Weingast, "The Role of Institutions in the Revival of Trade: The Law Merchant, Private Judges, and the Champagne Fairs", 2 *Economics and Politics* 1990, 1.
6. See *i.e.* Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law*, Cambridge, MA 1991, 34; Charny, *op.cit.* note 2, 379.
7. Charny, *op.cit.* note 2, 394 footnote 69, suggests that MacAulay's data can be interpreted in such a way.
8. David S. Clark, "Civil Litigation Trends in Europe and Latin America Since 1945: The Advantage of Intracountry Comparisons", 24 *Law and Society Review* 1990, 549; Heleen F.P. Ietswaart, "The International Comparison of Court Caseloads: The Experience of the Eruopean Working Group", 24 *Law and Society Review* 1990, 571.
9. Cross-country studies struggle with the problem of defining comparable data giving the differences in court structure, access to litigations for different types of disputes, etc. In addition, many countries do not collect systematic data on the types of litigants or defendants. Standardization of data, therefore, frequently relies on the number of cases per total population, rather than on the number of cases per entrepreneurs or firms. For a discussion of these methodological problems, see Ietswaart, *op.cit.* note 8.
10. For a principle critique of the empirical analysis of longitudinal litigation rates undertaken to date see Robert D. Cooter and Danicel L. Rubinfeld, "Trial Courts: An Economic Perspective", 24 *Law and Society Review* 1990, 533, who criticize the lack of model building and explicit testable hypotheses.

This paper attempts to explore this question, taking the Russian Federation as an example. Russia provides an interesting case study for the development of institutions to resolve commercial disputes. Commercial transactions between private parties were only recently legalized after almost seventy years of suppression and even criminalization of private trade and commerce. As a result, Russia suffers from a lack of legal institutions with a credible history of contract enforcement as well as from a lack of a history of a business culture that could provide a general source for a reputation-based sanctioning system. The introduction of market reforms creates a need to somehow fill this vacuum. The problem of creating credible institutions for conducting, performing, and enforcing has been aggravated in Russia by the extreme political and economic uncertainties with which the country has had to struggle with over the past years. In principle, norms and institutions for dispute settlement and contract enforcement may develop from three directions. First, the state may take the initiative by providing a court system and adopting contract laws. Second, private actors may develop a demand for such institutions and create their own contractual norms as well as mechanisms for solving disputes.[11] Finally, state and non-state institutions may interact and supplement or reinforce each other.

The remainder of the paper is divided into four sections. Section 2 provides an analytical framework for different types of contract enforcement institutions and the relation between them. Section 3 discusses the supply side of these institutions in Russia by exploring the origins of Russian Arbitrazh Courts and of selected standing arbitration tribunals (3.1). It also presents some quantitative data on the functioning of these institutions in practice (3.2). Section 4 analyses the demand for these institutions as reflected in the change in the number of cases submitted to Russian courts. The possible causes for the apparent lack of demand rooted in the court system itself (supply-side inefficiencies) (4.1), and those that are external to the institutions (4.2), are discussed. Section 5 draws some preliminary conclusions.

2. Contract Enforcement: State and Private Institutions

Contract enforcement is not a natural domain of the state. Prior to the advent of the state, transactions between private parties did take place and contrac-

11. For a strong argument that this may in fact be the more efficient way to reform the legal systems of the post-communist countries, see Paul Rubin, "Growing a Legal System, With Special Reference to the Post-Communist Economies", 27 *Cornell International Law Journal* 1994 No.1, 1.

tual parties were able to solve disputes and design dispute settlement as well as enforcement institutions that provided the basis for their transactions. The need for the state to provide courts that enforce contracts by private parties is usually associated with the growth of the size of the markets and, in particular, with the emergence of mass markets. With bigger markets and higher numbers of transactors, less mutual oversight and control is feasible. This also means that the incentives for opportunism are higher,[12] because sanctions for defection will be ineffective unless sufficient information transparency provides market participants with information about defectors.[13] Thus, there seems to be a relation between the growth of markets and the emergence of different types of dispute resolution and enforcement mechanisms. In small homogeneous social groups, where members usually engage in repeat dealings, reputation rather than formal institutions compels parties to comply with contractual obligations in the majority of cases.[14] The institutionalization or formalization of contract enforcement mechanisms was induced by the growth of the market, both in terms of total number of transactors and geographical size of the market. The Champagne Fairs of the Middles Ages, for example, emerged as a result of the expansion of trade. They provided not only a centralized exchange place, but also facilitated information on contract compliance and provided sanctions against non-compliance through exclusion from the exchange.[15] Once markets outgrew the constraints of a few regional exchanges, these mechanisms proved to be less effective. The state's furnishing of courts with the power to physically enforce contracts was the next step in the evolution of contract enforcement institutions and appears to have been even a necessary condition for the further expansion of business.

While this evolution of markets and dispute settlement institutions is intuitively correct and evidence for this evolution can be found especially in European history, sufficient counter evidence exists that questions the apparent high correlation between the size of markets and the types of dispute resolution and enforcement mechanisms used by market actors. First, international trade to this day functions without a superstructure of international

12. George A. Akerlof, "The Market for Lemons: Qualitative Uncertainty and the Market Mechanism", 84 *Quarterly Journal of Economics* 1970, 488.
13. On the importance for transparent information in mass markets, see Charny, *op.cit.* note 2, 419.
14. Lisa Bernstein, "Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry", 21 *Journal of Legal Studies* 1992, 115; Janet T. Landa, "A Theory of the Ethnically Homogenous Middleman Group: An Institutional Alternative to Contract Law", 10 *Journal of Legal Studies* 1981, 349. Milgrom *et al.*, *op.cit.* note 5, 19.
15. See Milgrom *et al.*, *op.cit.* note 5.

trade courts or much harmonization and codification of substantive law.[16] Common business standards prevail, or parties make a choice of both substantive law and arbiters for solving their (potential) disputes. This has been facilitated, for example, by the adoption of international conventions on the recognition of foreign arbitration awards.[17] Still, the world market as the world's largest market functions for the most part on the basis of private arrangements for dispute resolution, including the choice of forum and applicable law.[18] Second, without further qualifications, this evolutionary theory presumes that the succeeding institutions provide full substitutes for the previous arrangements. In the case of the Champagne fairs, more effective sanctioning systems – such as the expulsion of traders – appear to make reputation bonds less important, and state courts seem to render even these mechanisms superfluous, because they have the power to physically enforce contracts even against parties that do not belong to the same trade or exchange. This contradicts evidence that reputation bonds, hostages, collaterals, and sanctions based on membership are widely-used mechanisms even in today's mass markets with well developed court systems.[19] Third, while the importance of the state's ability to physically enforce contracts is often stressed, the fact that dispute settlement on the one hand and physical enforcement on the other hand are distinct and one could be provided by the state without it necessarily providing the other, is often overlooked. Thus, the state could theoretically leave dispute settlement to private parties and only provide a mechanism to enforce awards against parties who refuse to comply with the ruling of an arbiter – provided that the award meets certain standards. In fact, the emergence of collection agencies gives evidence that at least parts of the enforcement role of the state can be

16. Substantive law refers to contract, property, corporate law, etc. that regulate relationships between private parties. By comparison, procedural law regulates the extent to which laws and legal institutions may apply to such private relationships, including the validity of choice of forum and applicable law. An example for international substantive law is the United Nations Convention on Contracts for the International Sale of Goods (Vienna Sales Convention), of 1980. An example for procedural law is the Convention on the Law Applicable to Contracts for the International Sale of Goods, The Hague, 1985.
17. See *i.e.*, the 1958 New York Convention on the Recognition and the Enforcement of Foreign Arbitral Awards.
18. The fact that well-developed legal systems and effective court enforcement exists in many countries and parties may opt to subject themselves to these laws and institutions, of course greatly facilitates contracting.
19. See Charny *op.cit.* note 2, MacAulay, *op.cit.* note 4, and Bernstein *op.cit.* note 14; and Douglas North, *Institutions, Institutional Change and Economic Performance*, Cambridge, MA 1991, 122.

and often has been privatized as well.[20] In sum, the relation between state and private dispute settlement and rights enforcement, and the conditions under which private parties opt for one or the other, requires further analysis. The following discussion will be divided in two subsections that explore: 1) the nature of the relation between state and private institutions as complements or substitutes; and 2) the conditions that determine the choice by transactors between private and state mechanisms for dispute resolution.

2.1 Private versus State Dispute Resolution: Complements or Substitutes

Thirty years ago, the study by Stuart MacAulay on the relation between contract law and business relations was accorded a great deal of attention because it documented that contract law and state courts play all but a minor role in every day business life.[21] Even though standardized contracts were widespread and courts accessible, transactions were (and are) carried out without paying much attention to the fine print of contracts. Businessmen in general preferred to settle conflicts with their contractual partners without resort to lawyers or the courts. Other studies have reemphasized the importance of non-legal sanctions in different areas of the law and have observed the survival of private enforcement and dispute settlement mechanisms despite the existence of state-provided laws and courts (extra-legal mechanisms).[22] This empirical evidence suggests that state courts have not simply supplanted other institutions, but rather that state and private institutions coexist with each other. There are a number of possible explanations for this coexistence. One explanation would be that previous institutions have survived because the conditions in that particular trade or market have not changed considerably. Thus, the number of contractual partners and the scope of the market may still be limited and, therefore, the demand for state institutions low. This explanation appears to hold largely for the special set of norms and institutions governing relatively closed exchanges, such as the

20. Some have argued for the privatization of law enforcement in general. See e.g. Gary. S. Becker and George J. Stigler, "Law Enforcement, Malfeasance, and Compensation of Enforcers", *Journal of Legal Studies* 1974, 1. However, Landes and Posner show that law enforcement by private parties may well result in over-enforcement and thus greater social loss, particularly in the case of enforcement into non-monetary assets. See William M. Landes and Richard A. Posner , "Private Enforcement of Law", *Journal of Legal Studies* 1975, 1.
21. MacAulay, *op.cit.* note 4. Note that recent research in the US suggests that the reliance on formal law and court enforcement of contracts between businesses has been increasing since the late 1970s. See Galanter and Rogers, *op.cit.* note 3.
22. David Charny, *supra* note 2. See also Elision's analysis of *Order without Law*, Cambridge, MA 1991. Bernstein, *op.cit.* note 14.

diamond exchange analyzed by Linda Bernstein.[23] However, Bernstein also observes that these norms have been upheld even where the market transgressed its traditional boundaries.[24] Despite the fact that new diamond exchanges have opened in Asia and many more market players from diverse backgrounds have entered the market, the norms governing the exchange and the arbitration mechanisms used, have remained virtually unchanged.[25] Thus, many private mechanisms may be traced back to historical conditions that facilitated their emergence and also explain their survival, but others may not. As David Charny shows,[26] even in areas of the law which developed under the conditions of modern-type mass markets, parties frequently opt for non-legal sanctions that are tailor-made for the needs of the participants and flexible enough to allow for agreed changes where needed, even when they know that these arrangements are not enforceable under the law. In other words, even under a – relatively effective – legal system, non-legal arrangements are frequently preferred by parties.

If parties more often than not choose non-legal mechanisms to settle their disputes, why should they not always do this? The answer seems to lie in the indirect function of formal law and legal institutions which deter the breach of contracts and provide incentives for settling disputes outside the courts. The existence of legal standards stimulates out-of-court-settlement because parties can calculate and agree upon the likely outcome of litigation.[27] In addition, courts, if effective, may deter a breach of contract in the first place because parties face the costs of a law suit and possible loss of reputation. The virtue of an established court system is that these functions are provided to all market actors, irrespective of their own or their contractual partners' current membership in a particular trade or organization, or the geographical location of either parties. The significance of this aspect becomes clear when the need to adapt to changes in the economic environment is considered. In expanding and reallocating business activities and investments, market actors count on state courts as a fall-back position, whereas if there were no state courts the redirection of business activities would be more risky and costly.[28] Established legal standards also provide a common point of reference for traders from different locations and backgrounds, even where

23. See Bernstein *op.cit.* note 14.
24. *Ibid.*, 143.
25. *Ibid.*
26. See *supra* note 2.
27. George L. Priest and Benjamin Klein, "The Selection of Disputes for Litigation", 13 *Journal of Legal Studies* 1984, 1.
28. It is therefore not surprising that in newly-emerging markets, foreign investors are often the strongest advocates for improvements in the legal system.

parties decide to opt out of these standards and establish their own terms of reference.

Complete reliance on private enforcement mechanisms, by contrast, would require that under the conditions of mass markets, transactors have sufficient incentives to invest in private dispute resolution and enforcement mechanisms. To make such an investment attractive, the costs of these investments must be lower than the combination of their benefits and the potential benefits that could be obtained from opportunistic behavior. Whether or not this is the case will depend mostly on the degree of transparency of a market. A powerful and relatively cheap mechanism to induce parties to comply with, rather than breach, contracts is their own reputation. As has been pointed out, reputation bonds are the dominant enforcement mechanism in small homogenous societies with repeat dealings. This does not preclude the possibility that reputation bonds can also develop under the conditions of a mass market. However, for mass markets to be sufficiently transparent, a highly technological system of "computers used to monitor creditworthiness, or mass media used in advertising"[29] may well be required. Where transactors expect that opportunism will be detected and could harm future business, they are likely not only to refrain from breaching contracts but also to further invest in reputation, as this may generate returns in the future. Typical investments in reputation include the creation of brand names, trademarks, and good will.[30] However, trademarks and brand names are ultimately effective only because they can be enforced through the courts against those infringing them.[31] In other words, many of the reputation bonds and other private mechanisms we can observe in developed market economies rely – to a large extent – on the official legal system.

In sum, private dispute settlement and contract enforcement mechanisms exist side-by-side with state courts. State courts have not fully substituted private mechanisms, nor is there evidence that under the conditions of mass markets, private mechanisms alone would be effective. A somewhat different and much neglected question is whether, and if so how, state courts can function absent an underlying infrastructure of private enforcement and dispute resolution mechanisms. This question is of great importance for the development of contract law and legal institutions in the former socialist countries, particularly in Russia. At the outset of the current reforms, these countries had neither an effective court system nor a well-developed system

29. Charny, *op.cit.* note 2, 419.
30. Rubin, *op.cit.* note 11.
31. This becomes apparent when reviewing the history of enacted, but unenforced, laws on intellectual property rights in many countries.

of private dispute resolution mechanisms.[32] Many countries have meanwhile implemented structural court reforms and offer a formal system of adjudicating commercial disputes.

The purpose of this paper is to explore both analytically and empirically, whether this is a sufficient precondition for reducing the incentives for opportunism. There is ground for caution for overly relying on the court system. Legal sanctions are not only costly, but they also offer only a limited number of relatively crude responses to the potentially vast variety of breaches and malperformance. "The legal right to enforce a promise can reduce but never eliminate the insecurity associated with all temporally asymmetrical exchanges."[33] Without a web of private mechanisms that fine tune their relations, parties may tend to reduce the risk of engaging in transactions even where formal law and legal institutions exist. In doing so, they may prefer symmetrical exchanges where goods and payment are exchanged at once over asymmetrical exchanges where one party delivers in advance. This would considerably reduce the scope of business activities. Even if parties were willing to rely exclusively on the courts, this would soon result in over-burdening the system. The sheer number of disputes that occur in a non-transparent and uncertain economic environment would clog up the court system. Enforcement of contracts could become so costly and time consuming that it would soon undermine the credibility of that system. In other words, the effectiveness of courts depends largely on the number of disputes litigated, which depends on the total number of disputes that arise as well as on the proportion of these disputes that parties are able to settle out of court.

2.2 Determinants for Choosing between State and Private Contract Enforcement

Possible factors that determine the preference for reliance on the state-provided legal system on the one hand and for private dispute and enforcement mechanisms on the other hand are likely to be found both inside and outside the court system. Factors internal to the court system include the

32. The proposition that private non-legal norms governing exchange as well as dispute resolution mechanisms do not exist or are underdeveloped, of course, requires some further qualification. Russia, just as other former socialist countries, has a history of transactions outside the planning system. Because of their illegality or at best semi-legality, recourse to state enforcement was not available. Contractual partners, therefore, have relied heavily on reputation as well as on enforcement of contracts through physical violence.
33. Anthony T. Kronman, "Contract Law and the State of Nature", 1 *Journal of Law, Economics and Organization* 1985, 5.

speed, effectiveness and over-all costs of litigation, as well as the reputation of judges as independent and competent arbiters. Factors external to the court system include: 1) the existence of legal standards; 2) the prevailing (macro) economic conditions; and 3) the availability and relative costs of alternative enforcement mechanisms.

2.2.1 Legal Standards

Legal standards are at the cross-road between factors that are internal and those that are external to the court system. It is generally up to the courts to develop common legal standards. This is true even for civil law countries that rely to a much greater degree on codified statutes than common law countries. While codification offers a general guideline for legal standards, the application of abstract rules to specific cases requires extensive interpretation and a standardization of interpretation rules.[34] The importance of legal standards has been shown by Priest and Klein.[35] According to their findings, the propensity to litigate depends largely on a judgment by the parties on the likely outcome of litigation and the relative costs of litigation versus out-of-court-settlement. A decision to litigate is more likely where the outcome is uncertain, that is where the case could fall on either side of the established legal standards. In contrast, where the parties can predict the outcome in one way or another, out-of-court-settlement will be favored. Thus, legal standards serve to narrow the degree of uncertainty and, thereby, provide an incentive to settle out of court. This also implies that the creation of a court system – even one with competent and fair judges – may only be a first step in creating a legal framework for contract enforcement and needs to be supported by clear and enforceable rules.

2.2.2 Economic Conditions

The size of markets and the composition of traders play an important role in the development of norms, mechanisms, and institutions for settling disputes and enforcing contracts. In the former socialist countries, a mass market was introduced virtually overnight which, at least initially, was (and in many countries still is) highly non-transparent and uncertain. These conditions increase the incentives for opportunism, as such behavior is unlikely to be detected or sanctioned.[36] Mass markets rely on complex institutional arrangements that counteract these incentives, including advertising, rating institutions, or consumer protection groups. As long as these institutions are

34. See also Rubin *op.cit.* note 11.
35. *Supra*, note 27.
36. Akerlof *op.cit.* note 12.

absent, and the pay-offs for investment in reputation bonds comparatively low, opportunistic behavior will almost naturally prevail.

According to Williamson,[37] a low degree of litigation is a sign of a well-functioning market. Well-functioning markets are characterized by relatively low transactions costs, and therefore, disruptions in the form of disputes are less likely. Turning this argument around, it follows that malfunctioning markets should see a relatively high rate of litigation. This proposition is supported by evidence from litigation in countries that have suffered from high and hyperinflation. An interesting case study of the impact of inflation on civil litigation is the period of high and hyperinflation in Germany following World War I. German courts suffered during this period, from what H.C. Wolf has termed an "endogenous legal boom".[38] It was caused by a combination of inflation, a refusal by the courts to index contracts for inflation, and the resulting incentives for debtors to default even when faced with the likelihood of loosing a law suit. This, in turn, led to a vicious circle in which ever more debtors defaulted and the increasing number of law suits clogged up the system, thereby lengthening the procedure and further stimulating defection. As a result, civil law suits increased by 73% between 1919 and 1923, with similar increases in appeal procedures. The inability of the courts to handle disputes in a timely manner ultimately threatened to discredit the legal system. With stabilization achieved in late 1923, the number of suits declined by 39%.[39]

The reason why creditors may be more likely to sue in a high inflationary environment than under stable conditions follows from an analysis of the relative stakes of creditors and debtors. In a modification of their model on the selection of cases for litigation, Priest and Klein demonstrate that the relative stakes of the disputing parties changes their propensity to litigate. Even where they agree on the expected outcome based on their understanding of existing legal standards, litigation will occur where one of the parties' stakes by far exceeds those of the other.[40] The size of the stake is not only determined by the real value of the expected compensation, but also by the risk aversness of the respective party, because "risk aversion depresses

37. Oliver Williamson, "Transaction-Cost Economics: The Governance of Contractual Relations", 22 *Journal of Law and Economics* 1979, 3.
38. Holger Wolf, "Endogenous Legal Booms", 9 *Journal of Law, Economics and Organization* 1993, 181.
39. This scenario was repeated even more dramatically in Poland during the first year of the economic "shock-therapy" introduced in 1990. For an analysis of this data, see Katharina Pistor, "Laws Free the Market: Matches and Mismatches in Transition Economics", background paper for the *World Development Report* 1996, The World Bank, Washington, D.C., November 1995.
40. Priest and Klein *supra* note 27, 26.

the expected value of probabilistic returns".[41] Inflation, particularly high inflation, has important implications for the risk behavior of creditors versus debtors. In a high inflationary environment, debtors gain by letting time pass, as the real value of their debts declines. Creditors, on the other hand, loose with the passage of time, which makes them less risk averse for seeking court intervention.

2.2.3 Relative Effectiveness of Alternative Institutions

When discussing alternative types of contract enforcement, state courts are usually contrasted with private mechanisms, such as reputation, hostages and collaterals, as well as private arbitration. These are mechanisms that all rely on non-coercive forms of contract enforcement. Hostages or collaterals are in essence also non-coercive, because even though the execution of security rights often involves coercive elements, initially rights were transferred voluntarily. Contract enforcement as well as law enforcement by the state in general differ from these private mechanisms in that the state has the legitimate power to use physical force. Most legal systems limit the rights to self-justice by private parties and try to uphold the state's monopoly over physical power.[42] But this does not mean that states succeed in these attempts or that all states pursue such goals consistently. As a result, the emergence of armed private agents, both licensed and non-licensed, who at times also partake in the enforcement of contracts can be observed.[43] Where private contract enforcers are available relatively cheaper than the state court system and the probability of being charged by criminal law enforcers is low, these types of private contract enforcement may provide a viable alternative. Even where creditors do not choose a security firm to protect them, but, as is often the case in mafia-controlled sectors, the "protectors" impose themselves on entrepreneurs, this may still reduce the attractiveness of litigation: as regular

41. *Ibid.*, 27.
42. A partial exception are – mostly licensed – private security firms that have the right to use force in self defense.
43. The emergence of such (unlicensed) "security firms" or "mafia organizations" is often related to a weak state unable to provide effective enforcement institutions. The judgment as to whether the main object of the Mafia is indeed to provide "private protection" or "security" as a good as suggested by Diego Gambetta, *The Sicilian Mafia, The Business of Private Protection*, Cambridge, MA 1993, and thereby facilitates market transactions, is still out. Evidence both from Italy and from Russia suggests that this may be not more than a side aspect of Mafia activity. Moreover, Mafia structures may survive not, because they are faced with a weak state that provides a vacuum which is naturally filled by private protectors, but because parts of the state are intertwined with the Mafia and actively support it. For powerful evidence on this for the case of Italy, see Alexander Stille, *Excellent Cadavers, The Mafia and the Death of the First Italian Republic*, New York 1995.

payments to Mafia structures are already sunk costs, litigation would be an additional expense.

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As this overview has shown, the functioning of private as well as of state institutions appears to rely not only on the relative effectiveness of these institutions but also on external factors, such as the prevailing market conditions. Market actors will choose between private and state mechanisms to enforce contracts and settle disputes depending on the perceived relative costs of either mechanism, and the costs of a third option – coercive private enforcement. These relative costs are determined by a multitude of factors, among others the existence or non-existence of legal standards, the availability of private mechanisms for the particular transaction, and the relative stakes of the parties. In addition, both private and state institutions rely heavily on a common believe that these institutions function and are, in general, trustworthy. This aspect sheds light on the difficulty in establishing a rule-of-law based system in the former socialist countries because the state's role in upholding law and order has been seriously discredited. One of the key questions is, therefore, whether it will be possible for the state to recreate credible institutions, and whether this in combination with a more favorable economic environment will foster the demand for state-promulgated law and law enforcement.

3. The Supply Side for Contract Enforcement in Russia

The collapse of the planning system and the legalization of market transactions in Russia created a need for institutions that would settle disputes and enforce private rights, including property and contractual rights. A major step to meet this need was the creation of a system of commercial courts with the adoption of the Law on Arbitrazh Courts in July 1991 and the subsequent enactment of the Arbitrazh Procedural Code in April 1992.[44] The Arbitrazh Court system was established in addition to the already-existing system of

44. Zakon RF "Ob arbitrazhnom Sude", 4 July 1991, as amended 24 June 1992 and 7 July 1993, in *Zakon* No.2, February 1994, 4 (hereinafter 1991 Law on Arbitrazh Courts) and "Arbitrazhnii protsessual'nyi kodeks Rossiiskoi Federtsii", 5 March 1992, *Zakon* No.7, July 1992, 4 (hereinafter 1992 Arbitrazh Procedural Code). Both laws have been supplanted in 1995 by the 1995 Law on Arbitrazh courts, of 28 April 1995, effective as of 1 July 1995, "Ob arbitrazhnykh sudakh v Rossiiskoi Federatsii, *Sobranie zakonodatel'stva RF* No.18, 1 May 1995, item 1589; and by the Arbitrazh Procedural Code of 5 May 1995,

civil courts. The jurisdiction of the different court systems depends on the status of the parties involved:[45] claims involving entrepreneurs, private organizations, or state organs are filed with the Arbitrazh courts. All other cases are handled by the ordinary civil courts. Arbitrazh courts were established at city, *krai* (region), *oblast'*, and the level of republics within the Russian Federation.[46] The appellate and highest court for matters originating in the Arbitrazh court system is the Supreme Arbitrazh Court seated in Moscow.

3.1 Genesis of Existing Dispute Settlement Institutions in Russia

A closer look at the origins of the Arbitrazh Court reveals that the creation of this institution was not simply the product of a grand design with the purpose of providing effective state institutions for solving commercial disputes. It is at least partly the result of successful survival strategies pursued by forces within the old system. This is true for the Arbitrazh Court system, as well as for numerous arbitration tribunals or "tertiary courts" (*treteiskie sudy*), as they are referred to in Russian. The former is the direct successor of the former state arbitrazh (*Gosarbitrazh*) system, that was the logical extension of the planning system; the latter were provided for in the 1964 RSFSR Code of Civil Procedure.

The origins of *Gosarbitrazh* go back to 1931[47] when this quasi-court system was established for resolving conflicts between state enterprises which arose in connection with the implementation of economic plans. Despite its name, arbitrazh was not an arbitration tribunal. Not only did parties have no choice of the judges who presided over their claims but state arbitrazh was charged with overseeing legality of the operation of state enterprises in more general terms and, therefore, had a right to initiate proceedings itself. Arbitrazh, that was administered primarily by trained lawyers, also differed from a court system in that even formal acknowledgments of the independence of courts were omitted. Arbitrazh courts were

effective as of 1 July 1995, "Arbitrazhnyi protsessual'nyi kodeks Rossiiskoi Federatsii", *Vedomosti Federal'nogo sobraniia Rossiiskoi Federatsii* No.15, 21 May 1995, item 588. The following discussion will be based on the 1991/1992 codes. Major changes in the new laws will be noted.

45. Arts. 20, 29 1992 Arbitrazh Procedural Code.
46. Art. 10 of the 1992 Law on Arbitrazh Courts. Note that the 1995 Law on Arbitrazh Courts envisions the creation of an additional layer of courts called the federal regional courts (*federal'nye arbitrazhnye sudy okrugov*), see Art. 3, 1995 Law on Arbitrazh Courts.
47. For a historical overview, including the basic normative acts governing State Arbitrazh, see William E. Butler, *Soviet Law*, 2nd edition, London 1988, 121. For the practice of State Arbitrazh, see Harold J. Berman, *Justice in the USSR*, Cambridge, MA 1963, 124.

part of the state administration and its "judges" state officials within this same administration. Apart from interpreting and applying law, they had broad administrative powers enabling them to order other state agencies to take measures to facilitate the implementation of their rulings.[48] Moreover, State Arbitrazh had quasi-legislative powers in that it could issue normative acts to state enterprises, such as model contracts, standard terms for the delivery of goods, etc.[49]

Structurally, Arbitrazh consisted of two arbitrazh systems, State Arbitrazh (*Gosarbitrazh*) and departmental (*vedomstvennyi*) Arbitrazh. The jurisdiction of either system depended on whether or not the enterprises involved in an Arbitrazh proceeding belonged to the same economic council or ministry. If this was the case, the dispute belonged to the jurisdiction of departmental arbitrazh; otherwise, it was subject to *Gosarbitrazh*. *Gosarbitrazh* handled an impressive number of disputes. By 1938, 330,000 cases were litigated in this system.[50] In the 1980s, the number of litigated cases averaged 800,000 a year for the Soviet (federal) *Gosarbitrazh*. In Russia alone, 358,191 cases were decided in 1990.[51]

With the abolishment of the state planning system, the arbitrazh system underwent major changes. Many of the departmental Arbitrazh courts went out of business. A number of these courts have re-emerged in the new clothes of tertiary courts. Gosarbitrazh survived until 1991 when it was transformed into the Arbitrazh Courts. However, despite the dramatic changes in the purpose and function of the institution, the transformation left the staff of these courts essentially intact.[52]

In a similar fashion, many of the traceable tertiary courts were founded by former arbiters in the departmental arbitrazh, whose position had become superfluous, but who were not included in the transformation of Gosarbitrazh.

48. See Berman *op.cit.* note 49, 132, who reports a case, where the director of the railroad was ordered to provide more railroad wagons to the supplier so that shipments could be split into smaller units.
49. See Butler, *op.cit.* note 46, 125.
50. Berman, *op.cit.* note 46, 129.
51. B.A. Zolotukhin ed., *Kontseptsiia sudebnoi reformy v Rossiiskoi Federatsii*, Moscow 1992, 56; for an overview of available statistics on Arbitrazh procedures until 1980, see Ger P. van den Berg, *The Soviet System of Justice: Figures and Policy*, Law in Eastern Europe No.29, Dordrecht 1985, 169 and Appendix III, *ibidem*.
52. Note that the RSFSR Supreme Soviet resolution that enacted the Arbitrazh Court provided that until the election of judges, the former *Gosarbitrazh* judges were to continue under the new system. In fact, little changes were made, as an interview with V.V. Vitriianskii, deputy chairman of the Moscow-based Supreme Arbitrazh Court revealed. According to Justice Vitrianskii, many of the most experienced judges in the regions have sat there for twenty years. Vitrianskii himself worked from 1978 until 1986 as a consultant to RSFSR *Gosarbitrazh*, when he moved to the Council of Ministers before becoming deputy chairman of the Supreme Arbitrazh Court in 1992.

As a response, numerous former state arbiters established tertiary courts with the goal of serving the enterprises within the same industry sector as before. Thus, tertiary courts were established in the automobile industry, the textile industry, the agro-industrial complex, among others.[53] In some cases, a court without special affiliation to an industry sector was established by former state arbiters from various departments, such as in the case of the St. Petersburg tertiary court. Another, somewhat different example of a supply-led institution is the tertiary court attached the USSR Union of Lawyers established by decree of the USSR Council of Ministers. The juridical elite of the country – namely rank-and-file law professors and members of the international and maritime arbitration courts – are included in the list of potential arbiters of this court.[54]

A second set of tertiary courts was established at commodity and stock exchanges in 1991/92.[55] There is no substantive evidence as to the driving force behind the establishment of these courts. But the nature of the founders of the commodity exchanges, among whom were many a state bureaucrat as well as managers from state enterprises, indicates a close alliance with the old system, and numerous former state arbiters are said to serve at these courts.[56] The activity of the tertiary courts at commodity exchanges differs from exchange to exchange. The tertiary court at the Moscow Commodity Exchange by spring 1995 was said to have all but ceased to exist, and its chairman has meanwhile taken up the position of the chairman of the tertiary courts at the association of banks.

There is some evidence of arbitration tribunals that were in a sense more private establishments. Greif and Kandel report the creation of the Moscow Commercial Court by banks and insurance companies.[57] However, data on its actual activities have not been available. Severin reports the existence of a firm "Arbiter" in Moscow, where trained lawyers offered services as arbiters to settle commercial disputes.[58] By March 1995, this firm had changed its profile to an ordinary law firm because of the lack of demand for

53. For the statutes of these various courts Elena A. Vinogradova, *Treteiskii sud v Rossii*, Moscow 1993.
54. I am grateful to Professor Rimma F. Kallistratova for providing me with material on the staff and cases of this tertiary court.
55. See Vinogradova *op.cit.* note 52, Part III for the statutes of a number of these tertiary courts.
56. Timothy Frye, "Contracting in the Shadow of the State: Private Arbitration Courts in Russia", Paper prepared for the John M. Olin Seminar Series, "The Rule of Law and Economic Reform in Russia", Harvard University, suggests, that former state arbiters served at these courts. It is likely that they also promoted the establishment of these courts.
57. Avner Greif and Eugene Kandel, "Contract Enforcement Institutions: Historical Perspective and Current Status in Russia", *IRIS Working Paper* 1993 No.92.
58. Iurii Severin, "Treteiskii sud, tozhe instrument rynka", *Zakon* No.2 1994, 27.

arbitration services.[59] Other, more indirect, evidence on private dispute resolution suggests that attorneys of various law firms have served as *ad hoc* arbiters, but there are no data evidencing the number of disputes that they have settled.[60]

3.2 Arbitrazh and Tertiary Courts in Practice

The existence of state and private courts provides at least a formal basis for dispute settlement and contract enforcement. This raises the question whether these institutions serve as arbiters for settling commercial disputes in practice. Based on available data on cases decided by Arbitrazh Courts in comparison to those decided by tertiary courts, one has to conclude that if there are functioning institutions for dispute settlement, these are the Arbitrazh Courts, not the tertiary courts. As Table 1 shows, despite of the steep decline in litigation since 1991, the total number of court judgments issued by the Arbitrazh Court system still amounted to 190,000 cases in 1994.

Table 1. Economic Disputes at Russian Arbitrazh Courts

Year	Court Decisions	
	Number	%Change
1991	358,000	
1992	330,000	-8.4
1993	264,447	-30.0
1994	190,471	-27.9

Source: Unpublished data compiled by the Supreme Arbitrazh Court of the Russian Federation.

The total number of cases decided by tertiary courts appears to be much lower. Given the decentralized nature of these courts, comprehensive data

59. Information provided by Iurii Severin, interview by author, March 1995.
60. Report about a meeting at the Moscow Arbitrazh Court initiated by its chairwoman, with the participation of a number of attorneys who had been invited because of their involvement as arbiters in cases the Arbitrazh court subsequently enforced. *Khoziazstvo i pravo* 1993 No.6, 159.

are not available, but the data on the number of tertiary court judgments enforced through the Arbitrazh court system (Table 2), and results from interviews with arbiters at some of the courts (Table 3), yield some evidence on the performance of these institutions.

Table 2. Enforcement Orders for Judgments by Tertiary Courts

Year	Russia	Moscow City	St. Petersburg*
1993	541	231	7
1994	529	313	33
% Change	-2.2%	+73.8%	+470%

Source: Unpublished data of the Supreme Arbitrazh Court.
*St. Petersburg ranks second after Moscow with respect to the total number of enforcement orders granted in 1994.

Table 3. Practice of Selected Tertiary Courts[61]

Court	Affiliation	Year of establishment	Average # of cases per year	Total # of cases
Tertiary Court at Union of Lawyers	Union of Lawyers	1990	1	5
St. Petersburg Tertiary Court	None	1992	1-2	5
Tertiary Court at ASM Holding	Auto-Industry	1991	1-2	6
Iurinf	Agro-Industrial Complex	1989	150	750
Tertiary Court at the Association of Russian Banks	Banks	1993	50	50

Source: Interviews by author, conducted in March 1995; for the tertiary court at the Association of Russian Banks, see Balaian (*infra* note 62).

According to interviewees at tertiary courts, roughly 90% of all cases filed with these courts ends up being enforced by the Arbitrazh courts. Parties usually do not voluntarily comply with judgments. Consequently, physical enforcement becomes necessary, for which a special enforcement order granted by the Arbitrazh Court is required. If we assume that this number is correct and that in all judgments by tertiary courts for which enforcement was requested it was actually granted, the number of judgments issued by tertiary courts barely exceeds 600 in either 1993 or 1994. Arbitrazh Courts may, under specified circumstances, refuse to issue an enforcement order. According to Article 157 of the Arbitrazh Procedural Code, such refusal can be based on the absence of an agreement by the parties to refer a dispute to the tertiary court, violations of the procedure to appoint arbiters, or lack of information provided to the defendant to defend himself. In principle, judgments by the tertiary court are not subject to further review or appeal. However, Article 26 of the Temporary Provisions on Tertiary Courts extends the rights of Arbitrazh courts *vis-à-vis* tertiary courts by providing that the former may grant an appeal procedure on a case-by-case basis, or may refer a case back to the tertiary court, if the judgment violates existing legislation. While this provides the ground for closer scrutiny of judgments rendered by tertiary courts, it does not give the courts a general mandate to amend judgments taken by tertiary courts. There is also little evidence that courts have interfered more regularly, and commentators from tertiary courts usually hold that decisions taken by tertiary courts are final and binding.[62] Moreover, in practice standing tertiary courts had experienced little problems with obtaining enforcement orders, and the procedure for obtaining such an order was described as a pure technicality. Nevertheless, there are reasons to believe that a number of tertiary courts may be facing greater difficulties. Standing tertiary courts are required by law to inform the relevant Arbitrazh Court about their establishment and staff. Tertiary courts that had either failed to do so,[63] *ad hoc* arbitration tribunals spontaneously set

61. Data were gathered in interviews with the chairs or their deputies of these courts. Although more comprehensive data are not available, there are no indications that private arbitration tribunals have been prevalent in any region, business sector, or trade. See also Vinogradova, *op.cit.* note 52, 34, who states that the most successful tertiary courts may have handled 100 cases at the most since their establishment.
62. L.G. Balaian, "Treteiskii sud Assotsiatsii rossiiskikh bankov: itogi pervogo goda raboty, *Vestnik Vysshego arbitrazhnogo suda* 1994 No.10, 117, and interviews with chairmen at tertiary courts conducted by the author. By comparison, Vinogradova, *op.cit.* note 52, 40, stresses that potentially these provisions give the courts a supervisory role.
63. A representative from the Arbitrazh Court in Krasnodar complained at a conference on tertiary courts organized by the Institute of State and Law in December 1994 that many tertiary courts did not "register" and apparently in turn the Arbitrazh Court refused to enforce their decisions.

up to solve a specific case, or individual arbiters, may face more problems – precisely because their existence has not been documented – despite the fact that the latter have equal status as standing tribunals under current legislation. Even if we account for that, the numbers are still rather low given that there is no evidence on widespread refusal by arbitrazh courts to grant enforcement orders.

4. The Demand Side for Contract Enforcement in Russia

The number of existing tertiary courts contrasts with the volume of cases they have handled (see Table 3 above). There is apparently little demand for the services provided by these institutions. A possible explanation could be that private arbitration is ineffective unless the parties are willing to voluntarily comply with a judgment. In fact, where 90% of the cases end up in the courts anyway, arbitration tribunals seem to be superfluous. But even then, creditors are likely to receive an enforcement order quicker by referring a case to a tertiary court and subsequently applying to the arbitrazh courts for enforcement of the award, than if they initiated the case in these latter courts to begin with. The reason for this is that the procedure at tertiary courts is simplified, and, most importantly, a judgment is usually final and cannot be appealed against. As a result, tertiary courts could turn into collection agencies by initiating speedy enforcement of contracts that are, in principle, undisputed. The chairman of the tertiary courts at the agro-industrial complex actually suggested that this is where the future of his court lies. He claimed that one of the larger Russian banks (*Roskredit*) based in Moscow has introduced a provision in its standard credit contract that refers all disputes to the tertiary court at the agro-industrial complex. But there is little evidence that such a development has manifested itself already in practice.[64] The deeper reasons for the lack of demand for contract enforcement through these institutions are likely to be similar to those that may explain the steep decline in Arbitrazh court judgments between 1993 and 1994.

The total number of cases decided by Russian Arbitrazh Courts in its first year of actual operation (264,447 judgments) is quite impressive, although this is certainly well below the number of cases decided by the former *Gosarbitrazh* system. After this impressive start, the total number of judgments rendered by Arbitrazh Courts declined by 27% from 1992 to 1993 and by another 30% in 1994 (see Table 1). The reasons for this decline could lie

64. The interviewee was unable to give either specific data or a rough estimate of proportions of disputes filed by enterprises within as opposed to outside the agro-industrial complex.

in the ineffectiveness of the court system (supply inefficiencies) on the one hand, or in the lack of demand for the type of services offered by these institutions, on the other hand.

4.1 Supply Inefficiencies

Inefficiencies in the court system may be caused by: 1) their limited capacity or inefficiencies in handling cases; 2) entry barriers; or 3) a weak enforcement system that lowers the value of court rulings.

4.1.1 Capacity and Inefficiencies

Turning to the operation of the courts first, it is interesting to note that despite the often-stated inefficiencies of the Russian Arbitrazh Court system,[65] in terms of sheer mechanics, they are outperforming most of their counterparts in developed market economies. Arbitrazh courts are required by law to decide economic disputes within two months after a claim has been filed.[66] In 1993, a total of 3.4% of all cases took longer than the prescribed deadline, in 1994 1.5%.[67] Moreover, in view of the "crisis of non-payment", the Supreme Arbitrazh Court issued a judgment in August of 1994 that urged courts to decide disputes concerning non-payment for goods and services within one month.[68] The Supreme Arbitrazh Court keeps track of the performance of lower-level courts and each individual judge. Data are kept on their performance, including the ability to meet deadlines as well as the number of their judgments appealed against. How this tight supervision squares with the proclaimed independence of judges remains unclear, but it appears to ensure a fairly speedy procedure.

65. See *e.g.*, Paul Rubin and Jean Ellen Tesche, "Enforcement of Agreements in Russia", Paper presented at the John M. Olin Seminar Series, "The Rule of Law and Economic Reform in Russia", Harvard University, 11 April 1995; Timothy Frye, "Caveat Emptor – Institutions, Contracts and Commodity Exchanges in Russia", in: David Weimer ed., *Institutional Design*, Dordrecht/Boston 1995; and Avner Greif and Eugene Kandel, *op.cit.* note 56.
66. Art. 97 of the 1992 Arbitrazh Procedure Code. Note that such a provision may provide incentives for judges to dismiss claims rather than to engage in systematic investigations that are likely to be time consuming. Unfortunately, no data were available on the ratio of dismissals versus successful claims.
67. One may, of course, question the reliability of these data that have been compiled by the Arbitrazh courts. However, there are few possibilities for courts to skew these data, as cases would pile up eventually and reveal previous misstatements. Nevertheless, judges may cut their workload by dismissing claims for purely formal reasons or for lack of their jurisdiction and transferring them back and forth between the Civil Courts and the Arbitrazh Court system.
68. Letter of the Supreme Arbitrazh Court of the Russian Federation, 10 August 1994, N C1-7/op-557, Garant Data Base.

The high compliance rate with deadlines also suggests that courts have not been overburdened by cases. Moreover, the total number of cases previously handled by Gosarbitrazh can be taken as an indication that courts are operating below capacity, unless the nature of disputes requires considerably more time for settlement. While this may in general be expected given the complex legal issues involved in many commercial transactions, it should be noted that the largest category (almost 50% of all cases in 1994) of disputes litigated in 1993 and 1994 are simple charges for non-payment for goods and services (see row #1 in Table 4, below). These are likely to be often undisputed contracts that do not involve sophisticated legal issues or demand time-consuming investigations.

The area of litigation that has seen the steepest decline in the number of cases heard in Arbitrazh courts are miscellaneous contractual disputes. This could be attributed to the systemic change that the Arbitrazh court system is undergoing from providing an administrative procedure to harmonize enterprise relations prior and during implementation of plan contracts to a real court system. The incentives to file a suit under the old system were quite different from the incentives to litigate a commercial dispute. Under the planning system, litigation often served to allocate responsibilities in order to avoid sanctions in the future.[69] By contrast, in private litigation, parties usually try to receive adequate compensation for material losses they had suffered. Private litigants also face the costs of litigation, including the direct costs in the form of court fees and fees for attorneys, as well as an investment in time and possibly loss of reputation for filing a suit. Given the widespread hope among enterprise management that the state would eventually bail them out once more, they may have had little interest in trying to enforce their claims. Other sectors, such as the financial sector, apparently had less trust in the helping hand of the state: credit contracts witnessed the highest increase of over 130% among all dispute categories. Still, the total number of disputed credit contracts remains low and accounts for less than 1% of all cases litigated in the Arbitrazh court system in 1994.

It is also interesting to note that the number of cases concerning non-payment for goods and services decreased only by 8.3% and thus considerably less than other types of disputes. A possible explanation is that the tax these new duties, a ruling of the Supreme Arbitrazh Court sought to mitigate the impact of the 10% duty by urging judges in matters concerning non-payment for goods and services to make more frequent use of a provision in

69. For a similar point on China, see Donald C. Clarke, "The Execution of Civil Judgments in China", *The China Quaterly* 1995 No.141, 71.

administration requires firms to prove that they have attempted to collect a debt before they can write it off for tax purposes.[70] A "legal boom" or anything close to it causing court-administered contract enforcement to collapse under the burden of claims has apparently not taken place in Russia so far, despite high inflation, the extraordinary high default rate, and despite the fact that Russian courts, just as the courts in Germany before 1922, have refused to index contracts for inflation.[71] These data indicate that Russian creditors have shown a much lower propensity to file a case with the courts.

4.1.2 Entry Barriers

Another explanation for the low propensity to litigate are entry barriers that may prevent potential customers from making use of the system. The original duty (fee) structure for claims to be filed with the Arbitrazh courts depended on the nature of the claim and partly on its value.[72] Claims related to property rights were charged with a duty in the amount of 10% of the value of the claim which had to be paid up front. Only for disputes concerning the conclusion, change or cancellation of contracts, or for claims against the state, and applications for enforcement of judgments issued by tertiary courts, a fixed duty of 1,000 rubles was charged. The 10% up-front payment for property-related suits is likely to have deterred litigation, and increasingly so with the rising inflation rate. This duty structure was only overhauled in September 1994. The new duty structure introduces a combination of flat fee with a regressive fee levied on the value of the claim, which lowered the effective level of the fee.[73] Already prior to the introduction of the Arbitrazh Procedural Code allowing them to postpone payment of the appropriate duty until a court judgment has been reached.[74]

70. I am indebted to Jonathan Hay for calling this to my attention.
71. See Letter of the Supreme Arbitrazh Court of the Russian Federation of 26 January 1994 N OSH-7/OP-48, Garant Data Base, giving the court's general opinion of credit relations. It states that the provisions of a credit contract may not be changed unilaterally (by the creditor) unless the original credit contract so provides. The creditor is, therefore, prevented from increasing the interest rate and indexing it to inflation.
72. Art. 69 of the 1992 Arbitrazh Procedural Code.
73. Presidential Edict No.1930 of 17 September 1994, "On State Duties", Garant Data Base. The amount of the duty (fee) now depends only on the value of the claim, irrespective of its nature. Claims with a value of less than 10 million rubles, are subject to a duty of 5% of the value of the claim, but not less than a monthly minimum wage. For claims with a value of 10 million up to 50 million rubles, 200 thousand rubles plus 4% of the sum above 10 million rubles are charged. The effective duty for a 10 million claim would thus be 2%, and for a 50 million claim 3.6%. Similar duty brackets are established for claims valued up to 1 billion rubles. All claims exceeding this amount carry an effective duty of 2.13% of the value of the claim.
74. See Letter of the Supreme Arbitrazh Court of 10 August 1994, *supra* note 68.

Table 4. Types of Economic Disputes First Half of 1993 and 1994[75]

Type of disputes	First half of 1994		First half of 1993		Change
	Number	%	Number	%	%
Payment for goods and services	46,431	47.61	50,618	35.15	-8.3
Misc. contractual disputes	14,557	14,93	36,369	25.19	-59.86
Shipment	9,712	9.97	15,348	10.66	-36.7
Compensation for damages	9,624	9.87	17,750	12.33	-45.8
Sales contracts	5,377	5.51	8,833	6.13	-39.1
Conclusion, changes and cancellation of contracts	4,171	4.23	7,179	5.00	-41.9
Credit contracts	2,780	2.85	1,179	0.82	+135.8
Environmental damage	1,397	1.43	3,692	2.56	-26.1
Lease contracts	1,168	1.2	1.025	0.70	+13,9
Recovery of property	947	0.97	947	0.66	0
Voidance of contracts	925	0.95	845	0.59	+9.5
Confirming title of property	240	.25	198	0.14	+21.2
Violations of ownership rights	104	0.11	108	0.08	-3.7
Bankruptcy	85	0.09	1	0.00	
Total	104242	100	148983	100	-30

Source: *Vestnik Vysshego arbitrazhnogo suda* 1994 No.10, 105.
* Miscellaneous contractual disputes include export/import, insurance, borrowing and pledge contracts.

4.1.3 Effectiveness of State Enforcement

Another deterrent for using state courts to enforce contracts could be the absence of an effective state enforcement system. The weakness of the enforcement system is generally assumed: "the Russian state today is unwilling or unable to provide public enforcement of private contracts",[76] but hardly ever established on a factual basis other than the conclusion that the roots for weak contract enforcement must lie with malfunctioning institutions.

The established legal procedure for enforcing court rulings is fairly straight forward.[77] The standard type of enforcement of court judgments requiring payment by the defendant to the claimant (as opposed to transferring goods or other assets), is the confiscation of money in a bank account. Enforcement takes place after a judgment has entered into legal force, that is after the expiration of deadlines for appeal, or if a judgment was declared to be immediately enforceable. An enforcement order is sent to the defendant or directly to the defendant's bank. In the latter case, the bank is legally required to make payments to the claimant as specified in the court order.[78] In the event this order is not enforceable due to the lack of assets in the account, the court may change the original order and demand the confiscation or at least temporary arrest of property.[79] Such a ruling is then executed by so-called bailiffs or "court executioners" (*sudebnyi ispolnitel'*).[80]

Unfortunately, data on the number of cases in which state enforcement becomes necessary because defendants do not voluntarily comply with court judgments, or on the effectiveness of these enforcement mechanisms were not available. There are good reasons to believe that court enforcement has, in fact, been weak. It would be rational for a defendant expecting defeat in a law suit to move assets from a bank account to prevent seizure of theses assets, and an arrest of the account to prevent him from doing so[81] may come

75. A breakdown of court data from the St. Petersburg Arbitrazh Court reflect the same tendencies. This suggests that the overall picture is not driven by some outlier regions but rather reflects the situation in larger economic centers. I am grateful to Mr. Aprachin of the St. Petersburg Arbitrazh Court for making these data, as well as the data on all Russian regions for 1994, available to me.
76. Jim Leitzel, Clifford Gaddy, and Michael Alexeev, "Mafiosi and Matrioshki", *Brookings Review* Winter, 28.
77. The relevant Russian regulations are much shorter than comparable Western-type laws. This suggests rather a lack of concern for protecting the debtor's rights than weakness of enforcement rights courts, which are in fact rather broad.
78. Banks are threatened with loosing their licenses if they fail to comply with court orders, see Art. 151 of the 1992 Arbitrazh Procedural Code.
79. Art. 150, 153 in connection with part XI, of the 1992 Arbitrazh Procedural Code.
80. The Russian institution of "court executioners" is closer to the continental European than the Anglo-American model. The "court executioners" work on behalf of the courts rather than the executive. For this reason the term "bailiff" has been avoided in this translation.
81. Which is generally possible under part XI of the 1992 Arbitrazh Procedural Code.

too late. Enforcement reaching into other assets, by contrast, is much more costly and time consuming because it requires the confiscation and subsequent sale of movable or real property. There is a general perception among lawyers that the system of court executioners requires reform. But neither judges at arbitrazh courts nor their counterparts at tertiary courts dismissed outright the effectiveness of the present system. Confiscation was described as one of the strengths of the former and, in large parts, the still-existing state apparatus. This, of course, may also be a reason for claimants to distrust the enforcement system. Parties may hesitate to make use of a system that evokes memories of the past regime. In addition, they may distrust that system because they have no assurance that valuable and marketable assets will actually be confiscated, at least not without a considerable part siphoned off by the enforcers. Finally, the confiscation of property, organization of auctions, and cashing of the final proceeds – even under more favorable conditions – is a process which involves huge transaction costs.

To summarize, based on available data, an evaluation of existing institutions for dispute settlement and enforcement must remain inconclusive. There are many reasons to believe that their performance could be improved, not the least because their history does not suggest that they are able to deal with more complex commercial disputes in a meaningful way. Still, factors internal to the court system on their own do not convincingly explain the steep decline in commercial litigation. The next section will therefore explore factors external to the court system which may influence the demand for contract enforcement provided by the courts.

4.2 External Factors

In view of the relatively low and declining numbers of cases referred to such institutions, there seems to be an over-supply of these institutions in relation to the actual demand therefor. A number of factors external to the court system could serve as explanations for the lack of demand including: 1) economic conditions; 2) a changing customer base; 3) the unpredictability of court decisions; 4) the semi-legality of many market transactions; and 5) the availability of alternative enforcement mechanisms.

4.2.1 Economic Conditions

If the above analysis of the effects of high inflation on the propensity to litigate is correct, the case of Russia poses a puzzle. Despite continuous high inflation, steep recession, and extraordinary high default rates, litigation overall decreased rather than increased. A possible explanation would be that the steep recession led to a decrease in the total number of transactions

and, therefore, also downsized the number of potential disputes. One could then expect a steeper decline in litigation in regions that have suffered more from the recession, and less so in other regions. However, Russian data show no general pattern that would allow such a conclusion. A comparison of data on economic performance in different regions of Russia in 1993, and the percentage change of cases litigated in the corresponding Arbitrazh courts, gives a rather diffuse picture. The decline in litigation does not move together with the decline in production.[82] Similar results may be glimpsed from Table 5. It lists the regions with an above-average decline in litigation, which could hardly be more geographically and economically diverse. According to official data, the decline in production in these regions varied from -1.3% (Nizhnii Novgorod) to -23.7% (Republic of Dagestan).

4.2.2 Customer Base

The old customer basis of the successor institutions to Gosarbitrazh may be slowly eroding as a result of economic reforms. Companies unwilling to reform may grow more reluctant to seek court interference. And the demand by reform-orientated companies for services of institutions that they may associate with the past regime, may well be falling. A new client base has not been built up, and this may be difficult to accomplish. The history of the Arbitrazh courts is likely to deter entrepreneurs from seeking recourse to an institution that is dominated by enforcers of the previous planning system. In particular, new private entrepreneurs may decide to avoid courts rather than ask for their interference in commercial matters. Unfortunately, available data do not permit to draw any firm conclusions on the affinity of former state versus new private firms for court litigation. Arbitrazh courts do not keep data on the nature of claimants or defendants, their ownership structures, legal form, or the like. The only relation that could be tested is the one between progress in privatization and litigation volume. The rate of privatization in different regions does not have a detectable impact on litigation,[83] which is reflected in Table 6. Despite their difference in the proportion of companies that were privatized in these regions, they show almost identical declines in litigation volume.

82. The correlation coefficient is .028.
83. The correlation coefficient is .031.

Table 5. Regions with Above Average Decline in Litigation

Region	Litigation 1994/1993 %	Production decline 1992/1993 %
Republic Mordovia	-57.3	-7.8
Republic Dagestan	-48.0	-23.7
Iaroslavl	-40.8	-13.6
Saratov	-40.5	-7.7
Cheliabinsk	-38.4	-15.6
St. Petersburg/Leningrad region	-38.4	-11.2
Kemerov	-36.2	-9.5
Belgorod	-34.3	-3.2
Samara	-34.3	-8.2
Ivanovo	-34.1	-13.5
Moscow region	-33.3	-13.1
Novosibirsk	-32.8	-9.5
Nizhnii Novgorod	-31.9	-1.3
Tula	-31.6	-10.9
Republic Marii El	-31.0	-5.9
Krasnoiarsk	-30.5	-13.8
Penza	-30.1	-12.1
Voronezh	-29.8	-12.5
Tiumen	-29.7	-11.7
Moscow city	-29.2	-11.2

Source: *Goskomstat, Ekonomicheskoe Polozhenie Regionov Rossiiskoi Federatsii* 1994; and unpublished court data, Supreme Arbitrazh Court, Moscow.

Table 6. Size Distribution of Privatization and Impact on Litigation

Quartiles	Proportion of privatized enterprises	Litigation: % change 1994/1993
Minimum	3.98	-23.81
25 quartile	60.04	-29.7
Median	74.33	-23.07
75 quartile	82.55	-27.67
Maximum	100	-27.86

Source: *Goskomstat, Ekonomicheskoe Polozhenie Regionov Rossiiskoi Federatsii* 1994; and unpublished data of the Supreme Arbitrazh Court.

4.2.3 Unpredictability of Court Decisions

A general obstacle for having recourse to the courts is the lack of comprehensive and consistent legislation that would provide some basis for predicting the likely outcome of a court judgment. A reaction one would expect where written rules are incomprehensive, uncertain, or absent, is that private parties will invest in drafting their own documents – all else being equal. However, according to Arbitrazh court judges, this is often not the case. In many instances contracts are said to contain only the most elementary provisions. The reason for this lies only partly in ignorance of the relevance of legal aspects of a transaction. 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. Where neither contract documents, nor laws, nor customs of a trade are available for deciding a case, a contractual dispute can be settled in court proceedings only through a judgment ruling based on the appropriate burden of proof. In general, each party needs to prove the circumstances favorable to their claim or defense, respectively.

Therefore, a party alleging for breach of contract as a cause of action will need to establish that a contract was concluded and subsequently breached. In the absence of sufficient documents or witnesses, the claimant will fail to prevail in its cause of action, and, therefore, is unlikely to initiate one to begin with.

Even in the absence of secondary purposes such as tax evasion, clear documentation of a contract does not always pay off. With hindsight, a claimant may want to have been more specific in a contract, but *ex ante* it may have been perfectly rational to favor vagueness since – at that point in time – it was not clear which terms of the contract would become disputed and, thus, who may have to bear the burden of proof. This leads to a vicious circle in which both parties may decide not to make contracts too specific. While in a stable environment, parties are likely to opt for more certainty in their relations,[84] in a mass market characterized by uncertainty and the absence of information, opportunism is likely to pay off, at least in the short term. Parties to a contract, therefore, rationally speculate that the lack of clear rules will be to the disadvantage of their business partner, rather than to their own. Consequently, they will often fail to specify their contractual relations.

4.2.4 Semi-Legality of Market Transactions

An important impediment to seeking court intervention in the event of a breach of contract is that most commercial transactors will come to the courts with "unclean hands". Largely because of the existing tax structure and restrictive regulations[85] – but also because of other illegal aspects of a transaction, such as asset stripping and side payments – transactors have significant incentives not to disclose their activities to the state. Even if they did, chances are that these contracts would not be enforceable. Dual contracting, that is the conclusion of a fictitious contract to cover the actual agreement, where discovered by the courts, will render both contracts legally unenforceable. The 1994 Russian Civil Code[86] provides that both contracts

84. Even under optimal conditions, contracts will necessarily be incomplete because it is impossible to foresee all potential fallacies and the costs of detailed regulations are often deemed to outweigh their potential benefits.
85. Note that a recent government regulation, No.1418 "O litsenzirovanie otdel'nykh vidov deiatel'nosti" of 24 December 1994, *Rossiiskaia gazeta*, 6 January 1995, 6, had to make explicit that all activities not enumerated in this regulation may be conducted without license. See Art. 3 of this regulation.
86. Art. 170 of the 1994 Russian Federation Civil Code Part I, *Rossiiskaia gazeta*, 8 December 1994, effective as of 1 January 1995.

are null and void and, therefore, do not confer any rights or obligations upon either party.[87]

Even where the courts themselves do not inquire into the nature of a transaction, there is a clear danger that cases will come to the attention of other state agencies, such as the Procuracy. This is not an inconceivable scenario, because in Russia the powers of the Procuracy are not confined to criminal law; it still enjoys broad powers to oversee the observance of legality, including economic legality between private parties. It has, for example, the right to lodge protest against court judgments that – in the view of its officials – violate the law[88] and it may initiate bankruptcy proceedings against Russian companies.[89] Tax authorities are also likely to keep an eye on any documentation revealing the volume of transactions or profits of a company.

4.2.5 Availability of Alternative Enforcement Mechanisms

Litigation is an unattractive option for many transactors for the reasons discussed above. Where voluntary compliance cannot be expected, private coercion is the only viable option to secure transactions, even though their costs may exceed those of litigation and subsequent state enforcement. In the Russian context, private protection, though certainly not cheap,[90] is at least available given the ample supply generated by the collapse of the Soviet system. According to a recent survey by the *MVD*, Russia has 8,000 registered security firms, 38 registered associations of detective firms, and an additional 5,287 of non-registered security firms that are known. The study suggests that of the 60,000 employees who work in these security firms, 17,000 are former employees of the MVD and over 12,000 of the KGB.[91] These numbers refer to security firms only, and though they may partly overlap, do not account for organized criminal structures, such as the Mafia, that also provides coercive enforcement of contracts and property rights.

87. The purpose of this provision, which is standard in other civil codes, (see *e.g.*, Par. 117 German *BGB*), is clearly to deter parties from engaging in dual contracting. However, where the practice is as widespread as in Russia, it is more likely to deter parties from seeking legal sanctions for breach of contracts.
88. Art. 34 of the 1992 Arbitrazh Procedural Code.
89. Art 7 Zakon "O nesostoiatel'nosti (bankrotstve) predpriiatii", *Vedemosti RF* 1993 No.1 item 6, effective as of 1 March 1993. The Bankruptcy Law specifies that the Procuracy may initiate such a procedure in case of "deliberate or fictitious" bankruptcy and "in other cases specified by Russian legislation".
90. A single full-time guard at a "basic office" in Moscow is said to cost between $2,500 and 5,000 per month, see *Business Eastern Europe*, EIU, 10 July 1995, 5.
91. *Kommersant* No.10, 21 March 1995, 43.

The discussion of the external factors that might explain the drop in litigation in Russia in recent years suggests that there is a lack of demand for contract enforcement provided by the state. Some factors lie truly outside the court system, such as the prevailing economic conditions. Others are closely linked to the history of the courts and the resulting perception of the courts in the eyes of their potential clients. Both aspects seem to reinforce each other: under economic uncertainty, defection from private contracts, as well as semi-illegal activities, increases. This by itself decreases the likelihood that parties will seek recourse to the courts. The reputation of the courts and the Procuracy provides an additional disincentive for formal dispute settlement.

5. Conclusions

Where people engage in transactions, they generate a demand for contract enforcement, be it reputation bonds, self-enforcing mechanisms (*i.e.*, hostages), state, or private coercion. These mechanisms are not simply substitutes. Even where state enforcement is available, parties need to rely on private mechanisms to secure the majority of their transactions. Moreover, the effectiveness of state courts depends to a large extent on the existence of a minimum standard of rule abidance and a demand for norm-based dispute resolution. Where, for example, the majority of defendants refuses to comply voluntarily with court judgments, the power of coercion that the state in principle can provide is ultimately undermined, as enforcement on such a scale is not realistic. Non-coercive private mechanisms and state enforcement are, therefore, mutually complementary. Because of the complementary nature of the relation between private non-coercive and state enforcement, the creation of state courts – even in tandem with the creation of more consistent substantive laws – is not a sufficient condition for an effective system of dispute resolution and contract enforcement. Of at least equal importance is the creation of favorable conditions for rule-based contracting. In Russia, a main feature of the current business environment is its uncertainty caused mostly by an extreme scarcity of information. As a result, private parties either stick to the narrow circle of friends, relatives, and long-term business partners, or they bet on the advantages that a non-transparent market offers for opportunistic behavior. The state has done little in the past to provide more favorable conditions for private contracting. On the contrary, the failure to reform and rationalize the tax system, and to control inflation, have added to the uncertainties that accompany the transition process. The emergence of private violent enforcers is to some extent a natural side effect of this uncertainty. However, while many of the existing

security firms may provide substitutes for other forms of dispute settlement, depicting the powerful Mafia structures simply as a substitute for state institutions, is misleading. Available evidence on the "Red Mafia"[92] suggests that far from being substitutes for state agencies, it is often heavily intertwined with many of them. Moreover, providing contract enforcement is at best a side effect of most of the activities of the Russian Mafia(s). At the same time, the fact that Mafia and similar organizations are using coercion and are thereby undermining the state's monopoly over physical power suggests that it could easily continue to exist even with improved state institutions in place, thereby further undermining the credibility of state agencies to supply effective contract enforcement.

In conclusion, dispute settlement and the (non-violent) enforcement of private rights rely on a multitude of factors, of which the court system or the supply side of dispute settlement is only one. Economic conditions, the reputation of courts, and the general credibility of rule-of-law principles are other factors that have an impact on the demand for these institutions by the business community. In Russia, the early institutional changes aimed at providing a court system for handling commercial disputes have so far proved to be largely ineffective. The main reasons for this appear to lie less in the inefficiency of the system than in the lack of demand for the services that it offers.

92. English translation of the book entitled *Krasnaia mafiia* by A. Gurov, Moscow 1995.