УДК 341.49

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MECHANISMS OF CONTRACT ENFORCEMENT AND DISPUTE RESOLUTION

The paper highlights importance of informal private enforcement of contracts for understanding the functioning of court system in post-Soviet society. It analyses the notion of contract enforcement that derives from inter-disciplinary area of new institutional economics and distinguishes the features of public and private contract-enforcement mechanisms.

Keywords: contract-enforcement, public contract-enforcement mechanisms, private contract-enforcement mechanisms, New Institutional Economics.

This paper suggests that enforcement of contracts could be fruitfully addressed in legal studies by utilizing inter-disciplinary concept of contract-enforcement that derives from new institutional economics. The aim of this paper is to analyse the notion of contract-enforcement and its mechanisms including informal private arrangements that support court enforcement. By expanding the analysis to account for informal, extra-legal, socially-rooted arrangements one could better understand the functioning of legal system. This is especially relevant to the post-Soviet context where the gap between formal and informal is profound.

This paper relies on the works of scholars in broadly defined new institutional economics, such as North, Grief, Menard, Shirley, Milgrom, Weingast, McMillan, Woodruff and others. This approach combines economics, law, sociology, anthropology, and political science to understand social, political and commercial institutions [1]. It is focused on institutions as the interplay of written and unwritten rules, norms and humanly devised constraints, in their interactions with organisational arrangements [2, p. 1]. According to the founders of the new institutional economics, 'the inability of societies to develop effective, low-cost enforcement of contracts is the most important source of both historical stagnation and contemporary underdevelopment' [3, p. 54].

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. Opportunistic behaviour in these circumstances is more likely and requires sufficient effort in the establishment of an institutional structure for contract enforcement.

Based upon assumptions of the uncertainty of economic action and its social embeddeness, 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 [4], and of medieval Europe's merchant guilds by Milgrom, North, and Weingast [5]. 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 [6], and from the intimate religious rituals, celebrations, and life cycle events of the Ultraorthodox Jews who dominated the diamond industry [7].

Thus, 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.

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" [8, p. 427], and relies on North's definition of institutions as "formal rules and informal constraints that govern human behaviour" [3, 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 [9; 10; 11; 12; 13]. 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 [9]. 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 embracing the widest possible spectrum of arrangements to support contracts. Following the mechanism-explanatory view summarised by Hedstrom and Ylikoski [14], 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. 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 [15]. 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 is a system of mechanisms of a widely diverse nature that perform a variety of functions but are united by a single purpose – assuring contractual compliance and thereby contributing to the economic activity of society.

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 [16; 17]. 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 [3, p. 4], many scholars distinguish between formal and informal contract enforcement [18; 19; 20].

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 [21], however in practice they display a great deal of informality. Some scholars of post-Soviet transition understand informal activities as explicitly criminal [22] or only partly lacking legitimacy [23, 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 [24].

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" [25; 26] or "contractual" [27], indicating the actual or potential use of state law as opposed to extra-legal, extra-contractual enforcement relying on conventions, usage, custom, or expediential rationality [25, 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" [23, p. 26]. All of this renders the distinction between legal and non-legal quite ambiguous.

Given the variety of conflicting views, it is suggested to rely 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 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.

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 [18; 28]. 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" [28, 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 [4]. 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 that could be

addressed through thoroughly designed empirical research methodology. By expanding the analysis to account for informal, extra-legal, socially-rooted arrangements one could better understand the functioning of legal system. 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.

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МЕХАНІЗМИ ВИКОНАННЯ ДОГОВОРІВ І ВИРІШЕННЯ СПОРІВ

У статті обґрунтовано важливість неформальних приватних механізмів виконання договорів для більш повного розуміння судової системи в пострадянських країнах. Аналізується поняття виконання договорів з погляду міждисциплінарного підходу нової інституціональної економіки; розрізняються поняття публічних і приватних механізмів виконання договорів; характеризуються їхні основні ознаки.

Ключові слова: виконання договорів, публічні механізми виконання договорів, приватні механізми виконання договорів, нова інституціональна економіка.

Матеріал надійшов 07.02.2014