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**Punitive Damages for Contractual Breaches in Comparative Perspective:
The Use of Penalties by Russian Enterprises**

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Punitive Damages for Contractual Breaches in Comparative Perspective: The Use of Penalties by Russian Enterprises

The remedies available for breach of contract vary among legal systems. In most European countries, breaching parties may be required to pay punitive damages in addition to compensating those left in the lurch for actual losses. In the United States, by contrast, those wronged are generally limited to compensatory damages. Underlying this discord is a fundamental difference in assumptions about how economic actors will respond to the availability of punitive damages for contractual breaches. Comparative analysis provides a means of testing these assumptions when such tests are impossible using information from the United States alone. In this paper, we take advantage of the transition from state socialism to market capitalism in Russia to examine the impact of the introduction of penalties as a possible remedy for non-payment of contractual obligations. Drawing on evidence from a 1997 enterprise survey as well as research into doctrinal development, we investigate how Russian courts and industrial enterprises have responded to this new option, and inquire whether the outcomes that would be predicted by Western theorizing on contract law have come to pass.

Pros and Cons of Penalties

Freedom of contract is the basic principle guiding contract law in market economies. In an ideal world, economic actors would have complete freedom in setting the terms of their relationships with one another. In reality, however, governments routinely curtail this freedom through contract law. The benefits of unrestricted flexibility are weighed against perceived costs. Perhaps, the increased flexibility would allow powerful economic actors to increase inequalities. Or, possibly, there is a loss of economic efficiency from the increased flexibility when the restrictions help to reduce transactions costs. The extent to which governments intervene on such grounds depends in large measure on their views on how economic actors behave, *i.e.*, what policymakers believe will happen without such intervention.

Among the limitations that U.S. contract law places on freedom of contract is a general prohibition on the imposition of penalties for breach of contract. Those harmed are not left without recourse, but recovery is limited to compensation for actual losses, which are calculated on the basis of rules and formulas set forth in the law.¹ The goal is neither to punish the

¹A full discussion of the law governing contractual remedies is beyond the scope of this paper. See generally Section 344 of the Restatement (Second) of Contracts. As to contracts involving the sale of goods, the formulas are set forth in Article 2 of the U.C.C. and their theoretical underpinnings have been analyzed in countless law review articles and treatises, beginning with Fuller and Perdue (1936 & 1937). The damages allowed by law frequently fall short of compensating the aggrieved party for all of his losses (e.g., Perillo 2000, pp. 1093-94). See Craswell (2000) for a critique of the Fuller and Perdue framework.

breaching party nor to provide a windfall for those wronged.² Damages are generally determined at the time of the breach, though the amount may be stipulated in the contract under certain circumstances.³ Courts will enforce such provisions if they are deemed to be liquidated damages and not penalties.⁴ The rules governing the computation of contractual damages are relatively straightforward, to encourage parties to resolve disputes quickly and to keep the stream of commerce moving forward.

This non-enforceability of punitive damages under U.S. law is motivated by both practical and ideological considerations. Penalties have traditionally been forbidden in the contractual sphere because they amount to a punishment of the breaching party, which is considered inappropriate. This distaste for punitive sanctions has long been embedded in U.S. case law and was incorporated into the Uniform Commercial Code. Whether the prohibition is warranted is a much-debated question among scholars of U.S. contract law (e.g., Dodge 1999; Rustad 1998; Cavico 1990; Goetz & Scott 1977; Sullivan 1977). Eisenberg (1995, p. 226, n. 87) asserts that “the penalty rules resulted from a particular history of doubtful relevance in present-day life, and specifically from oppressive and unfair contracts enforced in a medieval, non-market economy.” As with most rules that purport to lay down a general standard, numerous exceptions have emerged that expose the less-than-firm foundation for the basic principle that breach of contract should not be punished.⁵

²To this end, those harmed by a breach of contract are required to mitigate damages. This obligation has long been recognized by case law and is incorporated into Article 2 of the U.C.C.

³Section 2-718(1) of the U.C.C. states that, “damages for breach by either party may be liquidated in the agreement but only at an amount which is reasonable in light of the anticipated or actual harm caused by the breach, the difficulties of proof of loss, and the inconvenience or nonfeasibility of otherwise obtaining an adequate remedy. A term fixing unreasonably large liquidated damages is void as a penalty.” See also Section 1-106 of the U.C.C. and Section 356 of the Restatement (Second) of Contracts.

⁴The difficulty of meeting the standards for an enforceable liquidated damages clause is illustrated by *Lake River Corporation v. Carborundum Company*, 769 F.2d 1284, 1290 (7th Cir. 1985), in which parties’ formula estimating damages was disallowed on the grounds that it constituted a windfall for one of the parties. See also *Raffel v. Medallion Kitchens of Minnesota, Incorporated*, 139 F.3d 1142 (7th Cir. 1998). For cases in which liquidated damages clauses were upheld, see *Swan King, Inc. v. Kang*, 243 Ga.App. 684 (2000); and *Kelly v. Marx*, 428 Mass. 877, 705 N.E.2d 1114 (1999).

⁵For example, punitive damages may be awarded for contractual breach where the conduct of the breaching party also constitutes a tort, such as fraud (Section 355, Restatement (Second) of Contracts). This exception has been actively exploited in recent years. Rustad (1998, p. 37) argues that, “the ‘hidden face’ of punitive damages is the rise of large punitive damages awards outside of personal injury. The number and size of punitive damages in business and contract litigation has grown in the past two decades. Unconscientious, deceptive, or opportunistic behavior in business contracts is increasingly punished by punitive damages. ... Punitive damages protects the method of contractual exchange by punishing and deterring business practices that bypass socially approved bargaining mechanisms.” For a

A full unraveling of the rationales underlying the prohibition on penalties for breach of contract is a task best left to legal historians. In this section, we merely sketch out the arguments for and against punitive damages in broad strokes. Our purpose is to generate a series of behavioral hypotheses that undergird these arguments, either explicitly or implicitly, in order to test these hypotheses using the Russian survey data.

Seen in their most positive light, the current rules act as an equalizer by protecting less powerful economic actors vis-à-vis more powerful counterparts. If penalties were permitted, those with power might use their leverage to extract onerous penalties from trading partners who failed to live up to their contractual obligations. Some economic actors might feel that they had no choice but to accept such terms. The most obvious examples occur when there is market power, for example when a manufacturer has only one supplier for a crucial input. The supplier might take advantage of the situation by pushing for burdensome contractual terms. The rule against penalties simply reduces the armory available to the supplier.⁶

This rationale for proscribing penalties has been criticized as paternalistic, particularly in light of the fact that most parties to business contracts are sophisticated and capable of weighing risks for themselves.⁷ Contractual parties are rarely evenly matched, yet courts rarely step in and second-guess the agreed-upon contractual language.⁸ As Goetz and Scott (1977, p. 592) have argued, “there is no reason to presume that liquidated damages provisions are more susceptible to duress or other bargaining aberrations than other contractual allocations of risk.” Thus, a crucial question is whether more powerful enterprises use the availability of penalty clauses to impose their will on trading partners.

discussion of this exception to the general rule as well as others, see Dodge (1999); Cavico (1990); Sullivan (1977).

⁶The parties still have free rein on price and delivery terms. As a rule, U.S. courts are reluctant to question or disallow the price terms of contracts. In the 1960s, some courts did look into form contracts of retail establishments and voided the price terms of these contracts on the grounds of unconscionability. E.g., *Williams v. Walker-Thomas Furniture Co.*, 350 F.2d 445 (D.C.Cir. 1965). See Leff (1969) for an authoritative discussion of the concept of unconscionability (article 2-302 of the U.C.C.). Contracts between businessmen are almost never voided by the courts on the grounds of unconscionability, even when the terms patently favor one of the parties. For a discussion in the agri-business context, see Hamilton (1994).

⁷Along similar lines, in *Lake River Corporation v. Carborundum Company*, 769 F.2d 1284, 1289 (7th Cir. 1985), Posner comments that, “it seems odd that the courts should display parental solicitude for large corporations.”

⁸For example, courts routinely enforce arbitration clauses in contracts between consumers and large corporations, such as computer manufacturers, cruise lines, and brokerage firms, notwithstanding the obvious disparity in their economic power and sophistication. E.g., *Hill v. Gateway 2000, Inc.*, 105 F.3d 1147 (7th Cir. 1997), cert. denied 118 S.Ct. 47 (1997). See Senderowicz (1999) for a survey of similar cases.

Power arises from more than market share. Another sphere in which one party to a contract might be much stronger than another is in knowledge of law and legal tactics. Galanter (1974) has convincingly argued that those who use the legal system regularly, *i.e.*, “repeat players,” have an advantage in their interactions with those who are less experienced (his “one shotters”). In a business setting, these repeat players can be expected to have honed their form contracts to serve their interests exclusively. In the most extreme cases, the contracts become the “statutes of a private government” ruled by the repeat player (Kenworthy, Macaulay, & Rogers 1996, p. 654).

Although Galanter does not address penalties *per se*, the logic of his argument applies. If penalties were allowed, they would likely become part of the legal arsenal of the repeat players, who might use them to take advantage of those less experienced in negotiation and dispute resolution. The repeat players would benefit from knowledge accumulated over time by their employees or their legal counsel. Indeed, in a common-law setting, we would expect repeat players to pursue changes in the rules governing punitive damages for contractual breach that would further benefit them at the expense of others. This sort of playing for the rules is unlikely in a country such as Russia with a civil-law tradition, but it is still reasonable to expect that those who regularly use litigation and other legalistic tactics to resolve problems with their trading partners to be more likely to use penalties as well. use accumulated knowledge and experience to take advantage of penalty clauses, using penalties more often than those less experienced. This behavioral hypothesis cannot be tested in the U.S. context because it poses a counter-factual. Thanks to the introduction of penalties for non-payment in post-Soviet Russia, we can explore the extent to which legal knowledge and experience with litigation influences behavior.

The extent to which economic actors take advantage of their market position, their legal experience, or other sources of power depends on the underlying relationship with their trading partners. As Macaulay (1963) has shown, economic actors frequently sign contracts without paying attention to the details buried in the fine print. Even when disputes arise, legalistic solutions are often resisted. Although the cost of litigation is the primary deterrent (at least in the U.S.), the fear of destroying the business relationship can also be determinative (Kenworthy, Macaulay, & Rogers 1996, p. 653). Hence, the existence of strong relationships will reduce the benefits from solidifying contractual promises with penalty clauses.

The strength of relationships will depend on the nature of the interactions between the trading partners. Personal factors can be important. The duration of productive ties between trading partners⁹ or the friendship of key managers can provide a basis for trust that will influence behavior when trouble comes. Hence, we hypothesize that penalties are more likely to be used in dealing with trading partners that are new, or more generally where the relational distance between the trading partners is greater.

⁹Williamson (1979) contends that as the length of the relationship between business partners increases, their contracts are more likely to be individually negotiated and contain idiosyncratic terms.

This same expectation follows from the arguments of law and economics scholars, although the reasoning is different. Posner, for example, has argued in favor of legalizing penalties for breach of contract. In *Lake River v. Carborundum* (769 F.2d 1284, 1289 (7th Cir. 1985)), he asserted in dictum that penalties can fairly be seen as an “earnest of performance”. As between the parties, they can serve as a useful signal between the parties, e.g., “the willingness to agree to a penalty clause is a way of making the promisor and his promisee credible ...” (ibid.). It demonstrates the commitment of the parties to the transaction.¹⁰ It may also have the effect of convincing a well-established company to sell its output to an unknown customer.

On the other hand, proponents of the law and economics approach see value in the current prohibition on penalties, which facilitates efficient breaches.¹¹ The rationale of the efficient breach was articulated by Posner in a 1988 opinion:

“Even if the breach is deliberate, it is not necessarily blameworthy. The promisor may simply have discovered that his performance is worth more to someone else. If so, efficiency is promoted by allowing him to break his promise, provided he makes good the promisee’s actual losses. If he is forced to pay more than that, an efficient breach may be deterred, and the law doesn’t want to bring about such a result.” (*Patton v. Mid-Continental Systems, Inc.*, 841 F.2d 742, 750 (7th Cir. 1988).

It is feared that penalties, if allowed, would tend to tip the scales in favor of sticking with existing contracts even when a more favorable option presented itself.¹² After all, if the party contemplating the breach had to pay penalties on top of actual damages, then he is likely to forgo the option. Posner lays out a possible scenario in *Lake River*.

“Suppose a breach would cost the promisee \$12,000 in actual damages but would yield the promisor \$20,000 in additional profits. Then there would be a net social gain from breach. After being fully compensated for his loss the promisor would be no worse off than if the contract had been performed, while the promisor would be better off by \$8,000. But now suppose the contract contains a penalty clause under which the promisor if he breaks his promise must pay the promisee

¹⁰In *Lake River*, the disputed clause was critical to convincing Lake River to make the capital investment in equipment necessary to bag the goods manufactured by Carborundum. Absent Carborundum’s guarantee of payment for a minimum amount of orders, set forth in the disputed clause, the transaction would probably not have gone forward. Notwithstanding his personal views, Posner held the clause to be a penalty and, therefore, unenforceable.

¹¹Not all legal scholars accept the premise of the efficient breach. E.g., Perillo (2000); Friedmann (1989); Macneil (1982).

¹²Posner draws a distinction between efficient and opportunistic breaches. The latter involve a situation in which “the promisor wants the benefit of the bargain without bearing the agreed-upon cost, and exploits the inadequacies of purely compensatory remedies ...” (*Patton v. Mid-Continental Systems, Inc.*, 841 F.2d 742, 750 (7th Cir. 1988)). He argues that penalties ought to be allowed for opportunistic breaches but not for efficient breaches. For a full discussion of this distinction, see Dodge (1999).

\$25,000. The promisor will be discouraged from breaking the contract, since \$25,000, the penalty, is greater than \$20,000, the profits of the breach; and a transaction that would have increased value will be gone forgone.” (*Lake River v. Carborundum*, 769 F.2d 1284, 1289 (7th Cir. 1985).)

Implicit in this argument are the assumptions that efficient breach is a normal aspect of behavior and that allowing penalties would change the propensity that parties have to engage in efficient breach. We examine these assumptions using the Russian survey data.

In sum, the foregoing gives rise to a series of hypotheses concerning the way in which economic actors will behave when there is the possibility of punitive damages for breach of contract. The first is that economic actors that enjoy market power will take advantage of their position to impose and enforce onerous penalty clauses. Second, enterprises that routinely use law and legal institutions to advance their interests will be more likely to use penalties. The third is that penalties would be employed more often when dealing with new or untested trading partners, or more generally where relational distance between partners is greater. Fourth, economic actors are prepared to put aside contractual obligations when better opportunities present themselves and, therefore, the threat of punitive damages will tend to discourage them from pursuing such efficient breaches.

Although these hypotheses, which flow directly from the scholarly debate over penalties, make predictions about the behavior of economic actors, they have yet to be tested empirically. With behavior under a regime of punitive damages not available, advocates in debates on allowing wider use of punitive damages have tended to premise their arguments on thought experiments. Through the use of comparative analysis, we go beyond thought experiment and examine actual behavior in the use of penalties. We focus on Russia, where penalties were introduced in the early 1990s as a remedy for non-payment of contractual obligations. We begin with a brief examination of the development of the legal doctrine, tracing the introduction of the new rule and its interpretation by the courts over the past decade. We then use the results of a 1997 survey of 328 industrial enterprises to test the viability of the four behavioral hypotheses.

Penalties Under Russian Law

A key element in the Russian economy's transformation from state socialism has been the changing nature of contractual relations. During the Soviet era, the sales of goods between state enterprises were memorialized by contracts, but these were hollow imitations of their counterparts in market-based economies. Superiors in the bureaucracy, rather than enterprise managers, picked customers or suppliers and set the essential terms of the exchange through the use of pre-approved form contracts. As the Soviet system disintegrated, enterprises gained autonomy. Post-Soviet managers of Russian enterprises are now free to do business with whomever they choose, and to negotiate the terms of exchange on a bilateral basis.

With the new freedom came new responsibilities. Among these was the obligation to pay in a timely fashion for goods and services received. Having grown accustomed to state bailouts

during the Soviet era, enterprises were unprepared for the rigors of the market. Many manufacturers continued to make shipments to their traditional customers. When payment was not forthcoming, they were in turn unable to pay their own suppliers. The domino effect gave rise to high levels of inter-enterprise debt. (See Ickes and Ryterman 1992, 1993.) As non-payment grew ever more commonplace, the lack of reputational sanctions became apparent. The combination of a business culture that did not condemn contractual breaches and the difficulties of recovering on the basis of a court decision resulted in widespread violation of contractual obligations.

The low level of contractual discipline among private trading partners created a dilemma. Policy makers could have done nothing, trusting in the power of market incentives to persuade economic actors to live up to their agreements.¹³ In principle, the law on the books was more than adequate to allow creditors to pursue delinquent customers aggressively. Penalties and interest, which tended to be conflated during the Soviet era, were contemplated by the law.¹⁴ Though the default rate was rather low – 3 percent per annum up to mid-1991 (art. 226, GK RSFSR) and 5 percent per annum thereafter (part 3, art. 133, Osnovy) – the law opened the door for contractual partners to negotiate a rate different from the default.¹⁵ The extent to which enterprises took advantage of this legal opportunity is difficult to determine because relatively few *arbitrazh* court opinions were published between 1990 and 1992 and there are no surveys that focus on the contractual remedies pursued by enterprises.¹⁶

Perhaps because economic actors had failed to show much initiative in using legal mechanisms to collect overdue debt, Russian officials took a more interventionist path. In May 1992, the government and the presidium of the legislature jointly issued a decree that authorized the imposition of penalties for delinquent payments for goods and services in the amount of up to 0.5 percent per day of the outstanding debt (Postanovlenie 1992). The hope was that these

¹³Compliance in established market economies stems from a combination of formal and informal sanctions. Some economic actors fear the coercive power of the state, which can be exercised through the courts. Even more are concerned with potential reputational damage, *i.e.*, with being labeled as someone who cannot be trusted. See generally, Williamson (1985); Macaulay (1963).

¹⁴For example, article 226 of the RSFSR Civil Code equates the two terms by inserting one of the words used for penalties (*peniu*) as a parenthetical following the word interest (*protsenty*).

¹⁵Scholarly commentaries (Kuznetsov and Braginskaia 1996, pp. 316-17) on these laws as well as interpretations issued by the Higher *Arbitrazh* Court (O nekotorykh voprosakh 1993, p. 30; Ob otdel'nykh rekomendatsiiakh 1993, p. 106) provide further confirmation of the right of economic actors to set the rate of interest to be charged on delinquent payments.

¹⁶In Russia, *arbitrazh* courts have jurisdiction over economic disputes between enterprises (including contractual disputes). These courts are distinct from the courts of general jurisdiction and the constitutional court. See generally Hendley (1998a & b), Hendrix (1997), Halverson (1996).

penalties would deter non-payments.¹⁷ Yet the principle of freedom of contract was honored in that penalties were not made mandatory. Rather, both their use and the amount (within the 0.5 percent ceiling) was left to the discretion of the party harmed by the breach. The party so wronged did not have to make the decision about seeking penalties at the time of formation, but could exercise this prerogative at the time of breach.¹⁸

The civil code, passed in 1994, reflected this same approach by endorsing the use of penalties for breaches of contract (arts. 329-332, GK). The code authorized penalties in general terms; the precise amount was not stipulated. The 1992 decree remained in force, thereby providing an absolute limit on the penalties recoverable for non-timely payment. In addition, the civil code allowed claims for interest as part of non-payment claims (art. 395, GK). The purpose was to ensure that the “victims” of breaches did not suffer doubly due to inflation. The interest rate was pegged to the discount rate of the Russian Central Bank (RCB).¹⁹ The statute of limitations was three years.²⁰

The implications of these measures, especially the 0.5 percent per day rate, can only be understood in the context of fluctuations in inflation. From the beginning of 1992 through the first quarter of 1994, the rate of wholesale price inflation was continually, and often substantially, greater than 0.5 percent per day.²¹ During that period, the RCB discount rate usually did not match inflation, favoring debtors whose interest payments were linked to this rate. Moreover, in Russia neither penalties nor interest are compounded when preparing a court claim, the effect of

¹⁷This represents a continuity with Soviet law. During the Soviet period, penalties were mostly assessed for late delivery or poor quality. The amounts were minuscule. Their purpose was less to punish the wrongdoer in monetary terms than to send a signal to the ministry that something was wrong. In post-Soviet Russia, penalties have taken on a very different function.

¹⁸This constitutes an exception to the general rule that penalties can be recovered only if based on a written agreement between the parties (Art. 331, GK). The 1992 decree provides a distinct legal basis for claiming penalties, and so need not satisfy the requirements of the civil code (Postanovlenie 1992).

¹⁹Article 395 states that rate to be imposed is to be the prevailing bank rate at the locale of the creditor. Trial courts and litigants found this rule confusing. In a July 1996 decree, the Higher *Arbitrazh* Court clarified that, as a general rule, the discount rate for the RCB as of the day the claim is filed or as of the day the decision is rendered should be used. Postanovlenie 1996, pt. 50, p. 17.

²⁰The RSFSR Civil Code, which was in effect until mid-1991, had a six-month statute of limitations for cases involving interest or penalties (art. 79). The Fundamentals of Civil Legislation extended the viability of contractual claims for a three-year period (art. 42, Osnovy), which was incorporated into the new civil code (art. 196, GK).

²¹ The facts on interest rates and inflation rates used in this and the following paragraphs are taken from various issues of the *PlanEcon Report*: XI(7-8) April 7 1995; XII(1-2) January 31, 1996; XII(35-36) October 14, 1996; XIII(47-48) December 31, 1997; XV(8) April 27, 1999

which is to favor debtors in times of high inflation. In light of these facts, the apparently large 0.5 percent rate was not in fact very high in the early years of transition. Until the second quarter of 1994, debtors were relatively favored and had an incentive to delay payment even if they intended ultimately to pay fully on all debts, interest, and penalties.

During 1994, the situation changed dramatically. The Russian government implemented a strong stabilization program, one consequence being that the RCB discount rose substantially above the rate of inflation, sometimes by 10 percent a month. The rate of wholesale price inflation dropped considerably: from mid-1994 to mid-1997 (the time of our survey), the 0.5 percent penalty rate was much higher than the rate of inflation, so that the real value of penalties on a delayed payment would rise with time. As a consequence of the high real interest rate and an allowed penalty rate now much higher than the rate of inflation, delay now favored creditors. With the civil code incorporating a three-year statute of limitations for contractual claims and imposing no duty on parties to mitigate damages, there was an incentive to wait until the last moment to file claims. The practical result was that penalties often dwarfed the original debt, even though interest thoroughly compensated for inflation, a situation that *arbitrazh* judges found deeply troubling.²²

Russian economic actors embraced penalties enthusiastically and quickly. In a review conducted by one of the authors of hundreds of *arbitrazh* court files in Moscow, Saratov, and Ekaterinburg, the increasing use of penalty clauses in contracts stood out during the early years of reform. Equally striking was the tendency of complainants to request penalties and the amenability of the courts to such requests.²³ The very popularity of penalties, in combination with the changing rates of inflation, created a new problem. Although introduced as a means of combating inter-enterprise arrears, after mid-1994 penalties had the unexpected effect of increasing the real burden of arrears. The amount of the penalties awarded by courts in the mid-1990s often exceeded the original debt, even though interest compensated for inflation. The paradoxes in this situation were not lost on either the participants or the *arbitrazh* court judges. After all, there was little hope that losing defendants would be able to pay these judgments. Yet the debt (including the penalty) would be attached to their bank accounts. The debts did not have the effect of pushing enterprises into bankruptcy, as Western advisers might have predicted, but instead managers worked to avoid having any of their income stream pass through their bank accounts (Hendley 1999). This, of course, served no one's interests.²⁴ Indeed, recognizing the

²²For a more detailed discussion of cases in which penalties exceeded the basic debt, see Hendley (1998a). As we note below, this uneasiness with mounting penalties contributed to the subsequent willingness of judges to accede to debtor-petitioners' requests to reduce penalties.

²³Two-thirds of the 52 non-payments cases reviewed by Hendley in 1997 included a demand for penalties. Penalties were awarded in 86% of these cases (Hendley 1998a).

²⁴Whether the same would be true today is unclear. Thanks in part to the adoption of a new bankruptcy code in 1998, bankruptcy has become more commonplace. The number of bankruptcy petitions considered by the *arbitrazh* courts has increased from 2,269 in 1997 (Sudebno-arbitrazhnaia

futility of obtaining huge but unenforceable judgments, some enterprises began to rethink penalty clauses. Rather than allowing penalties to mount unchecked, they have set caps equal to a pre-determined percentage of the value of the contract.²⁵

A doctrinal shift can be perceived as early as mid-1996, though it did not become widely accepted until 1998. A July 1996 joint plenary session of the Russian Supreme Court and the Higher *Arbitrazh* Court resulted in a ruling that suggested that creditors could no longer seek both penalties and interest, but had to elect one or the other (Postanovlenie 1996, p. 17). Several 1996 cases follow this line of argument to conclude that asking for both represented an effort to “double dip.” Other courts continued to allow recovery of both interest and penalties through 1997.²⁶ By 1998, few complainants even made an effort to recover both, since the courts preemptorily disallowed such efforts (*e.g.*, Hendley forthcoming (b)). Justifying this policy shift in theoretical terms is difficult, given that interest and penalties are patently distinct from one another. By recovering interest, the creditor is compensated for losses suffered due to lack of access to overdue payments. Penalties are, of course, a punitive remedy designed to punish the party in breach and are intended to act as a negative incentive. Notwithstanding this theoretical conundrum, the *arbitrazh* courts dogmatically regard these two remedies as duplicative, and refuse to award both. This interpretation harkens back to the Soviet era when there was no practical difference between interest and penalties. In essence, the courts will only enforce one clause that calculated the amount owed in percentage terms. If the contract contained both interest and penalty clauses, then the plaintiff had to decide which remedy to pursue (Postanovlenie 1996, p. 17). Further complicating matters is the difficulty of recovering for

1998, p. 22) to 10,933 in 1999 (Sudebno-arbitrazhnaia 2000, p. 9).

²⁵A review of *arbitrazh* court files from 1996 and 1997 reveal a propensity to cap penalties at 8-12% of the value of the contract (see generally Hendley 1998, p. 325). Not all enterprises maintained this policy. For example, a Moscow consumer goods manufacturer that had voluntarily imposed a cap on penalties in its 1997 form contract of 30% of the value of the contract eliminated this provision in 1998. The director of sales saw it as a misguided attempt by top management to win the favor of customers. Her preference was to allow penalties to mount and then to use the possibility of reducing them as a means to encourage delinquent customers to pay.

²⁶Whether both interest and penalties may be recovered in non-payment cases is a thorny question under Russian law. The difficulty arises from the language of article 395 of the civil code, which permits the recovery of interest only if the contract provides for no other type of interest. Some courts have interpreted this language to prohibit dual recovery of interest and penalties because contractual penalty clauses are typically expressed in terms of percentages, which these courts view as a type of interest. Thus, asking for both is considered an attempt at double-dipping. *E.g.*, AOZT Brokerskii Dom Al'fa v. AOOT Nitkan, Case No. 4615/96-2, Saratov (unreported, decided December 23, 1996). Other times courts allow both remedies, on the theory that interest is compensatory and penalties are punitive. *See, e.g.*, ZAO Torgovo-proizvodstvennaia firma Rasoptprodorg v. KP Pokrovsk-LTD, Case No. 4889/96-27, Saratov (unreported, decided December 10, 1996).

incidental losses in connection with contractual breaches.²⁷ Though the Russian civil code ostensibly allows for the recovery of such damages (arts. 15, 393-94 GK), the standard of proof has proven impossible to meet. We are unaware of any cases in which creditor-plaintiffs have recovered amounts in categories other than debt, interest, or penalties (see Hendley 1998a).

A second important change is reflected in the increasingly activist role of *arbitrazh* court judges. Beginning in 1997, these judges began to exercise a moderating influence on the exponential increase in penalties by intervening to reduce them.²⁸ The civil code grants discretionary authority to judges to reduce penalties if the amount is deemed to be “clearly disproportional” (art. 333 GK). This statute lay dormant in the early years of the transition, but has been used more regularly since 1997.²⁹ Although it empowers judges to act on their own initiative to reduce penalties, they rarely act without some prompting from the debtor-defendants. Penalties in excess of the debt are frowned upon.³⁰ Though informal conversations reveal judges to be frustrated by, and critical of, creditor-plaintiffs who take full advantage of the statute of limitations and wait a full three years before filing their lawsuits, the Higher *Arbitrazh* Court has specifically forbidden judges from considering this issue when deciding whether to reduce penalties under article 333 (Obzor 1997).

²⁷By contrast, U.S. law allows aggrieved sellers to recover “commercially reasonable” expenses resulting from the breach (section 2-710, U.C.C.).

²⁸Initially, the embrace of this discretionary power was more enthusiastic in Moscow than in the outlying regions. None of the 31 non-payment case files Hendley reviewed in Saratov and Ekaterinburg in the summer of 1996 raised the possibility of reducing penalties. Likewise, in her observation of trials in these *arbitrazh* courts over the course of several weeks, neither the court nor the defendants discussed reduction of penalties. An incremental change in behavior was evident a year later. Ten of the 52 case files reviewed in Saratov in 1997 demanded penalties in excess of debt. A reduction in penalties was discussed in four of these cases, and they were actually decreased in two cases. The Moscow City *arbitrazh* courts exhibited a greater willingness to entertain the possibility of reducing penalties and, in fact, to reduce them. In virtually every case involving penalties that observed at the trial, appellate, and cassation level during May 1997 the question of whether to reduce the amount was raised and discussed. See generally Hendley (1998a).

²⁹Neither *Kommentarii* to the civil code pays serious attention to this statute, which suggests that the danger of suppliers abusing penalties had not been contemplated by the drafters. See Kuznetsov & Braginskaia (1996, p. 286); Sadikov (1995, p. 345). In July 1997, the Higher *Arbitrazh* Court signaled the emerging importance of this statute by issuing a summary of cases involving article 333 and commenting on how trial courts should use their discretionary power (Obzor 1997). See Samokhina (2000) for a more up-to-date summary of the use of article 333.

³⁰See generally Hendley 1998a. In Romania, the law stipulates that penalties cannot exceed the amount of the debt (Art. 7, par. 3 Romanian Law no. 76/1992, published in the Official Gazette, no. 178/July 28, 1992). The courts have consistently followed this statutory rule, including the Supreme Court of Romania, Commercial Section (see CSJ.SC. Dec. no. 459/October 18, 1994).

This history reflects on the hypotheses introduced in the previous section. The very first years of transition favored debtors and the courts were amenable to requests for penalties. As penalties grew larger in both actual and percentage terms, both economic actors and *arbitrazh* judges responded by modifying their behavior on penalties. A definitive determination of the cause for these changes is not possible. It is tempting to link the courts' limitation on the amount of penalties that could be recovered to the effects of the stabilization program, which had the effect of reducing inflation rates to levels far below the 0.5 percent a day penalty rate. Perhaps this macro-economic development influenced judges, though there is no direct support for such a conclusion.³¹ Alternatively, these behavioral responses, from the higher reaches of the judicial system, from lower level judges, and from enterprise themselves, suggest reservations among the system's actors concerning an unchecked use of penalties that can favor one party to the transaction. Perhaps these systemic responses reflect, to some degree, the same inchoate sense of the unfairness of penalties that seems to underpin several of the arguments traditionally made against allowing penalties under U.S. law. It does suggest that allowing the use of penalties where they are now banned might not be followed by a free-for-all, but would be muted by considerations that are similar to those that have prompted the banning of penalties in the past.

The Use of Penalties by Russian Enterprises

This summary of the law governing penalties and the shifts in its interpretation by the *arbitrazh* courts confirms the importance of penalties as a remedy for non-payments in post-Soviet Russia. It does not, however, provide much insight into when penalties are used or by whom. We explore these questions, drawing on the results of a 1997 enterprise survey. Although the survey does not allow us to trace the history of the respondent enterprises' use of penalties, it does provide us with a rare opportunity to determine what sorts of enterprises have taken advantage of the availability of penalties, examining the four hypotheses set forth above.

The Survey and the Data. Between May and August of 1997, we surveyed 328 Russian industrial enterprises. The sample included enterprises from six cities (Moscow, Barnaul, Novosibirsk, Ekaterinburg, Voronezh, Saratov), with each city represented roughly equally. In each enterprise, Russian surveyors administered different survey instruments to four top managers: the general director, and the heads of the sales, purchasing (supply), and legal departments.³²

³¹Interviews with trial level *arbitrazh* judges reveal their lack of comfort with the fact that the penalties were routinely in excess of the actual debt. Along similar lines, the official statements by the Higher *Arbitrazh* Court (*e.g.*, Postanovlenie 1996) do not tie policy change to macro-economic trends, but to legal principles.

³²When the enterprise did not have a formal department, the person who carried out the relevant duties answered the survey.

The enterprises were concentrated among ten industrial sectors.³³ Enterprise size ranged from 30 to 17,000 employees, with a median of 300 and a mean of 980. Most of the enterprises were established during the Soviet era, and about three-fourths (77%) are privatized. In virtually all of those privatized, some stock was in the hands of insiders, and nearly a quarter of the sample was entirely owned by insiders. Outsiders (non-employees of the enterprise) held some stock in 50% of the sample enterprises.

As part of the survey, we asked a number of questions concerning the characteristics of transactions involving sales of output or purchases of inputs. One such characteristic was the use of penalties. In this paper, we focus on the results of two basic questions posed to the head of the sales department. The first asked what percentage of sales contracts included a penalty clause for late payment. This is, of course, one measure of the use of penalties. It captures both the basic knowledge of the availability of punitive damages as a remedy for non-payment and the willingness to make penalties an explicit part of the bargain. On the other hand, it does not capture the extent to which enterprises sought and obtained penalties when their customers failed to pay. We therefore asked a second question to ascertain how often our respondent enterprises actually collected penalties when payment was overdue.

The responses to these two questions reflect conscious choices by the enterprises at two critical moments in the transaction: the formation of the contract, and the breach of that contract due to non-payment. In the Russian context, the seller's form contract is typically used (Hendley, Murrell, and Ryterman 1999), which means that the seller usually makes the initial proposal on the use of penalty clauses. The purchaser is not obligated to accept all of the terms proposed, but often does. Since purchasers traditionally do not put forward their own form contracts,³⁴ the specific terms of the contract will usually correspond more closely to the seller's preferences. Similarly, when payment is not forthcoming, it is the sales director who decides how to proceed, *i.e.*, whether to resolve the problem informally or to seek penalties and other remedies available through the courts. At both points in time, it is the seller who sets the course. For this reason, it is more appropriate to focus on the responses of sales directors rather than on the results of the

³³The industrial sectors are (number of enterprises in parentheses): food processing (67); textiles, clothing and leather (60); fabricated metal (34); machinery and transport equipment (23); electronics (34); chemicals and petroleum (33); construction (18); wood products (8); paper and printing (5); and other (46).

³⁴The "battle of the forms" takes on a different character in Russia. Harkening back to the Soviet era when the basic form could not be altered, purchasers dissatisfied with the sellers' forms propose changes by attaching addendums to the original form contracts, known as "protokols of disagreement" (*protokoly raznoglasiia*). If signed by both parties, they act to modify the terms of the contract. Although such *protokoly* are the exception rather than the rule, the most common rationale for them is to alter (usually to delete) the default penalty clause(s). For more detail on these *protokoly*, see Hendley, Murrell, and Ryterman (1999); and Hendley (forthcoming (b)).

analogous question posed to the procurement director.³⁵ By analyzing the responses of the sales directors, we are able to assess two critical manifestations of the use of penalties: their inclusion in sales contracts and their activation in case of breach.

Descriptive Statistics. Table 1 provides an overview of the use of penalties among our sample of enterprises. The basic patterns are not entirely surprising. Russian enterprises are more likely to include penalties in their sales contracts than to act on them when their customers fail to pay. Evidently, some enterprises incorporate penalty clauses into their form documents as a negative incentive, *i.e.*, to encourage on-time payment, without intending to impose penalties on delinquent customers as a matter of course. The existence of the clause enhances the range of options available to the enterprise when dealing with recalcitrant customers. (Though the inclusion of penalty clauses in contracts is not a legal prerequisite for the collection of penalties, we show below that inclusion seems to be a behavioral prerequisite.) Even if rarely used, the possibility of imposing penalties constitutes a potentially valuable bargaining chip during negotiations regarding overdue payments. The sharp divergence between behavior on the inclusion of penalty clauses and that on recovery of penalties is reflected in the mean responses to the two key questions. When asked the percentage of sales contracts that contained penalty clauses, the mean response of sales directors was 52.69%. Indeed, 42.4% of the surveyed enterprises stated that all of their sales contracts have penalty clauses. By contrast, a majority (60.8%) of the enterprises had never actually collected penalties when payment was overdue. Indeed, there is a large group of enterprises (19% of our sample) that simultaneously include penalties in all of their contracts, have customers in arrears, and never choose to collect penalties. The mean response of 0.74% confirms the rarity with which enterprises in fact seek and obtain punitive damages in case of late payments.

When examining the frequency of inclusion of penalty clauses in contracts, a quick glance at Table 1 suggests three major categories of enterprises, those that never include them (non-users), those including them sometimes (occasional-users), and those that include them in all their contracts (routine-users). However, Table 2 demonstrates that the critical distinction is between non-users and users (occasional plus routine). Non-users exhibit behavior on the collection of penalties that is qualitatively quite distinct from users. In contrast, occasional-users and routine-users seem quite similar to each other. This point is borne out by other statistics describing basic characteristics of the three different groups of enterprises, set forth in Table 3. The same pattern appears as in Table 2: non-users are quite distinct from both types of users, but occasional-users and routine-users do not look very different from each other. These observations are important in choosing how to analyze enterprise decisions on the use of penalty clauses in contracts.

³⁵We asked the procurement director what percentage of the enterprise's contracts to purchase inputs included a penalty clause in case of late payment. We also asked how often the enterprise had paid penalties when payment had been overdue. With regard to both questions, the behavior of the respondent enterprise would have been in reaction to decisions made by the seller.

Choosing the Relationships to be Estimated. When making the choice of which relationships to estimate and which statistical methods to use, it was necessary to ask whether an enterprise's decision to include penalty clauses in its sales contracts is necessarily based on exactly the same factors as the decision on how frequently to include such clauses. Loosely speaking, an affirmative answer would imply that occasional-users are qualitatively intermediate between non-users and routine-users. The above observations suggest that this is not the case. Therefore, it is necessary to analyze separately two phases of enterprise decision making in contracts. We first examine whether an enterprise has ever included penalty clauses in its sales contracts. Then, as to those enterprises who have chosen to include such clauses, we examine the decision on how frequently they are used. This separation of decisions is quite intuitive and common in many spheres of life: decisions on how many courses to take in college do not reflect exactly the same set of factors as decisions on whether to go to college; decisions on whether to obtain medical treatment reflect different factors than do decisions on how much treatment to obtain.

The same conclusion applies to decisions on the imposition of penalties. First, we examine the factors that influence whether an enterprise has ever collected penalties. Then, as to those enterprises who have taken this step, we analyze how often penalties are actually collected. The results that follow amply substantiate the basic decision to analyze each of the two basic enterprise choices (use in contracts and imposition) in two separate stages (whether to use/impose at all and if so how frequently).

We thus use the results of four statistical analyses examining relationships that capture the factors affecting the following enterprise decisions:

- (1) has the enterprise ever used penalty clauses in its contracts?
- (2) among those enterprises that use penalty clauses, how frequently are they used?
- (3) has the enterprise ever collected penalties from delinquent customers?
- (4) among those enterprises that collect penalties, how frequently are they collected?

Below we repeatedly use the numbers (1)-(4) to refer to each of these relationships and the corresponding statistical analyses. Analyses (1) and (3) include the full sample of enterprises; (2) includes only enterprises that have used penalty clauses in their sales contracts; (4) includes only enterprises that have actually collected penalties. The basic statistics on these four dependent variables appear in Table 4a.

Table 4b presents the pertinent information on the explanatory variables included in the four statistical analyses. The choice of explanatory variables was driven by the hypotheses set forth above and by our general understanding of the nature of Russian enterprises, the Russian economy, and the Russian legal system. To the extent that a full understanding of the properties of a variable requires a more detailed discussion of its construction and the reason for including it in the analysis, we provide that discussion when we examine the results pertinent to each variable.

The Results in General. We make the judgment that little would be added to the

substantive discussion by presenting the statistical methods in detail and by thoroughly listing all the results in their full numerical glory. Thus, we opt for simplicity and brevity in order to concentrate on the substantive issues, relegating discussion of methods to a brief Appendix. The methods used in estimating the four relationships vary according to the statistical properties of the samples used, but all methods fall in the general category of regression analysis. We present the four estimated relationships in Table 5 and refer to them as regressions (1)-(4) below.

Table 5 adopts a straightforward format for the presentation of the results, simply noting information on which variables are significant at conventional levels of statistical significance (20%, 10%, 5%, and 1% in two-sided tests).³⁶ The levels of significance appear in each pertinent cell of the table together with a sign indicating the direction of the relationship between explanatory and dependent variable. Despite the absence of numerical detail, this table contains most of the information that is usually used by scholars when absorbing the results of empirical exercises: it is the sign-significance pair that is crucial. Where a cell is blank, the variable is not significant, even at the 20% level, and we do not use information on the sign of the relationship.

Before turning to discussion of particular variables, some brief overall remarks are in order. First, as will be clear in the following discussion, the four estimated relationships reflect different phases of enterprise decision-making, in which the importance of different factors varies. This suggests caution in interpreting the results in Table 5. Non-significance of a variable in one estimated relationship might not be crucial, if that variable appears as significant in other regressions. Thus, it is the significance of a variable in one or two relationships that tells us that this variable plays a role somewhere in enterprise decision-making.

The patterns of significance of different types of variables across the four estimated relationships can tell us something about the nature of enterprise decision-making. For example, those variables that are significant in explaining whether penalty clauses are ever used in contracts (regression 1) capture different phenomena than those related to the frequency of use (regression 2). Law-related variables³⁷ seem relatively more important for the decision on whether to use penalty clauses at all than for other decisions. Variables on markets and on relationships seem more important in these other decisions. This suggests a learning process within the enterprise regarding penalties. When convinced through experience or independent investigation of the potential value of penalties in contractual relations, the enterprise tends to bring this realization to all of its transactions. In other words, the resources committed to including penalties are a fixed cost to the enterprise and when these costs are low enough it will commit to the inclusion of penalty clauses as a general rule. But given this commitment, those fixed costs will not affect whether penalty clauses are used in any specific contract. Rather it is the nature of the relationship with the particular trading partner and the situation in the pertinent

³⁶The results in their full numerical detail are available on request from the authors.

³⁷The law-related variables in Table 5 are: plaintiff activity, legal knowledge, and obstacles to using courts.

market that will influence how frequently such clauses are used.

The overall pattern of the results seems to imply that inclusion of penalty clauses in contracts is almost a behavioral (but not legal) prerequisite for the collection of penalties. Ninety percent of enterprises that collect penalties include them in contracts. In regression (3), the sole variable that is highly significant is the use of penalty clauses in contracts. (Indeed it is significant at the 1/10 of 1% level.) This is consistent with the discussion in the previous paragraph. Law-related factors are most determinative in the use of penalty clauses. But after that, intensity of use is much more dependent on the market situation of the enterprise. This point is dramatically illustrated in Table 6 for one important law-related variable, the enterprise's propensity to appear in court as a plaintiff. For the subset of enterprises that use penalty clauses or for the subset that imposes penalties (regressions 2 and 4), behavior on penalties is unrelated to willingness to initiate litigation.

As this observation illustrates, the results of regression (4) are somewhat paradoxical. This confirms that the analysis of the frequency with which penalties are collected is different than the other analyses. In contrast to the decision to include penalty clauses, the seller has much less control over whether it ultimately collects penalties. The seller makes the threshold decision as to whether to seek penalties. But whether penalties are recovered depends both on the financial viability of the delinquent buyer and the amenability of the court to the seller's demands. Unfortunately our data do not permit us to analyze the impact of the buyer's financial condition on the propensity to seek and collect penalties. Even more difficult to account for is the role of reputation. There may be an inverse relationship between an enterprise's commitment to use penalties as a threat and its need to collect on penalties. The economic actor that is able to establish a reputation for follow-through on contractual enforcement may have less need to go after penalties because its trading partners pay on time. Interviews with Russian enterprise managers confirm that tough choices have to be made as to which suppliers are paid when resources fall short and that the repercussions of non-payment (whether penalties or other reprisals) are critical in deciding how to allocate scarce resources.

Market Power. The first hypothesis that we examine is that enterprises with market power will likely take advantage of their position to impose and enforce onerous penalty clauses on the less powerful. We turn to the Russian case to examine this hypothesis.

Anecdotal evidence provides some support, albeit suggestive. Published case reports indicate that utilities, which are natural monopolies in Russia, tend to be quite aggressive in seeking punitive damages. When unpaid, they often wait to initiate legal action until the statute of limitations is ready to expire (3 years), and then demand the accrued penalties which, at the typical rate of 0.5% per day of the outstanding debt, can be substantial. The astronomical sums being sought and awarded to utilities as penalties in the mid-1990s certainly contributed to the willingness of *arbitrazh* court judges to use their discretion to reduce penalties (art. 333 GK). In addition, a number of enterprises that enjoy sectoral dominance have taken advantage of their position to force far-reaching penalty clauses on their trading partners. For example, recognizing

the cachet attached to being known as one of its suppliers, a large Moscow department store insists on contractual clauses calling for the supplier to pay penalties if sales targets do not meet projections. Although the department store has not had occasion to sue the suppliers with whom we have spoken, the one-sided nature of the sales contract set the tone for the overall relationship, turning the supplier into a supplicant eager to stay in the good graces of the department store.³⁸

Using the survey data, we examined two indicators of market power: control over the form contract and market share.

Market Share. The share of the domestic market controlled by the seller is a straightforward indicator of market power. If the fears of the U.S. critics of punitive damages are correct, then we ought to find a positive relationship between market share and the use of penalties. Such results are also suggested by anecdotal evidence from our case studies of Russian enterprises. The statistical analysis gives relatively weak support for this prediction. Table 5 shows that market share plays no role in the basic decision on whether to include penalty clauses. The minimal significance found with respect to regressions (2) and (3) are not strong enough to suggest that it is universal practice for enterprises with market power to take advantage of their position by forcing their trading partners to include penalty clauses or by collecting penalties when payments are overdue.

These results are not as surprising as they might appear at first glance. Penalty clauses are not the only means available for powerful enterprises to pursue their goals. Perhaps the respondent enterprises that dominate their markets use this very dominance to assert their will over their contractual partners. Their partners (customers) may be sufficiently frightened by the prospect of not being able to do business with the dominant enterprise that they toe the line on payment and other issues of importance. In other words, the dominant enterprises may have learned to manipulate the situation to their advantage without the need to resort to the rather clumsy remedy of penalties. If these market dominating enterprises are accustomed to using informal methods of managing their relationships with customers, then they are unlikely to resort to the courts and, therefore, unlikely to have much use for punitive damages, which usually require a court order. Moreover, it follows from this analysis that market dominating enterprises would be unlikely to seek and collect penalties from delinquent customers. If this is the case, then the statistical results do provide information pertinent to debates on whether to allow penalties. These results simply do not add much force to the theoretical argument that punitive damages must be forbidden because they enhance the power of those enterprises that already have market power.

³⁸A similar dynamic was observed in the auto industry. Prominent assembly plants use their market position and their suppliers' patent lack of alternatives to press their own one-sided contracts onto suppliers. The contractual language is inventive in defining grounds for assessing penalties against the suppliers. See Hendley (forthcoming (b)).

Control Over the Form Contract. Recognizing that power flows from control of the content of the initial draft of the contract, we asked the survey's legal respondents whether the enterprise had a form contract that is usually used in sales transactions. We anticipated that enterprises regularly using a form sales contract would be more likely to exercise that power by insisting that penalties be included in the final version of the contract. We were less confident that use of a form contract would translate into a willingness by sellers to pursue punitive damages if payment was not forthcoming. Our hesitation is underscored by the fact that the sellers' control over the form of the contract may be less a gauge of raw market power than of inertia. During the Soviet era, tradition dictated that the supplier's form be used and there is strong evidence that the Soviet norm still holds given that 65.5% of the respondent sales directors reported using their own form (Hendley, Murrell and Ryterman 1999).

The analysis confirms the expected positive relationship between the existence of a seller's form contract and the use of penalty clauses in sales contracts. As Table 5 indicates, the significance of the relationship persists for both the fundamental decision as to whether to include penalty clauses at all (at the 10% level) and for the frequency with which such clauses are included (at the 5% level). Assuming that the goal of sales directors is to negotiate the best deal possible, including keeping options open for their enterprise in case of breach, it is entirely reasonable for them to try to insert penalty clauses in sales contracts. The presence of such a clause does not obligate management to seek punitive damages, but it puts the buyer on notice. From the seller's perspective, the ideal outcome would be for the penalty clause to act as a negative incentive that discourages breach by the buyer. Perhaps the negative sign on the form contract variable in regression (4) is due to such negative incentives: a buyer that believes its trading partner will follow through on a penalty clause may be less likely to renege. In other words, an enterprise that gives a clear sign that it will impose penalties will end up imposing them less often than an enterprise that does not send a clear message.

Reorganizing Relationships with Customers. In an effort to understand the priorities of enterprises in the chaotic transition environment, we asked the general director to evaluate the relevance of different strategies for ensuring the survival of the enterprise. The transition from a planned economy toward a market economy gave rise to a high level of instability at the enterprise level. Arrears (including back wages and taxes as well as debts to trading partners) grew dramatically and many enterprises legitimately feared they would not survive. One of our questions highlighted the role of relationships by asking for an assessment of the importance of "reorganizing the [respondent] enterprise's relationships with other enterprises" on a scale from 0 to 10. The responses are embodied in the variable summarizing the emphasis on reorganizing relationships. We assumed that enterprises committed to reorganizing their relationships had the power to do so, perhaps deriving from some special feature of their market position. Enterprises that had such power might be more likely to include penalty clauses in their sales contracts and impose them if necessary, as a means of signaling the changing relationship.

Table 5 shows that merely having the desire to change the relationship is not enough. On

its own, this variable is not significantly related to the use of penalties in any form. Given that few enterprises pay penalties voluntarily even when contractually obligated to do so, collecting penalties generally requires a court order which, in turn, requires litigation. Perhaps a commitment to using legal measures is important as well. Thus, we created a variable that measured a simultaneous commitment to reorganizing relationships and to using law and legal institutions. This variable was derived by combining the answers to two survey questions on enterprise survival strategies that were posed to the general director: the one discussed in the preceding paragraph and an analogous one that asked about the enterprise's commitment to a strategy of "using law and legal institutions to protect the [respondent] enterprise's interests."

The results of this analysis, as reported on Table 5, indicate that it is not the goal of reorganizing relationships, per se, that matters for penalties, but rather the combination of the two strategies. The "emphasis on reorganizing relationships" variable is not significant but the "simultaneous emphasis on reorganizing relationships and using law" is significant in the two regressions that analyze the frequency of including penalty clauses and collecting penalties (regressions 2 and 4). This composite variable is highly significant (at the 1% level) in explaining the collection of penalties. Because collecting remedies is almost inevitably a legalistic remedy, these results suggest the importance of legal activism in using penalties, to which we now turn.

Legal Activism. Economic actors who are habitual users of legal tactics will usually be more comfortable with using such tactics than those who are unfamiliar with them. The willingness to resort to legalistic solutions reflects a level of comfort with the formal legal system that is not universal in any society, and is certainly not widespread in Russia, where citizens grew inured to the instrumental use of law in Soviet times and where many continue to be skeptical of law. The propensity to use legal tactics can also be diminished by lack of knowledge and experience. Learning the details of the substantive law of remedies and gaining an appreciation of how it operates in daily life can be a painstaking process. As the foregoing discussion of the law governing penalties in Russia illustrates, merely keeping up with the current interpretation of the basic law would be time-consuming. The enforcement of penalties usually requires a court order, raising the specter of litigation. Mastering the intricacies of litigation takes time. Experienced litigants are at an advantage when dealing with neophytes. Those enterprises with an accumulation of legal knowledge and experience will therefore have advantages in the use of penalties.

In Russia, as elsewhere, only a small fraction of contractual disputes ever end up in court.³⁹ Support for the hypothesis that enterprises who are comfortable using legalistic tactics to

³⁹Our survey illustrates this point emphatically. We asked respondents to answer a series of questions about a recent transaction. We learned that for every 100 transactions, 24 involve some level of dissatisfaction, i.e., a potential dispute. Of these, 16 are resolved through informal complaints, 7 are resolved through threats of litigation, and only 1 is actually litigated. Also See Hendley (1998d and forthcoming (a)) for an analysis of caseload trends in Russian *arbitrazh* courts at the trial and appellate

solve problems with trading partners are more likely to include and enforce penalties is found in the review of case files of contractual disputes at the *arbitrazh* courts conducted by one of the authors. This research reveals that the vast majority of petitioners were seeking to collect penalties from defendants (Hendley 1998a). The bases for such claims were either penalty clauses incorporated into the text of the contract or the 1992 Decree. The latter evidences an impressive command of the underlying law.

Detailed case studies of a select group of the surveyed enterprises suggest that knowledge and experience with legalistic tactics operates as a necessary but not sufficient condition for their use. While lack of knowledge might forestall the use of penalties and even the initiation of litigation, a thorough grounding in Russian contract law does not necessarily translate into full-scale pursuit of all available remedies, including punitive damages (Hendley, forthcoming (b)). Managers might choose not to include them in the sales contract or not to go after them in the case of a breach because the value of maintaining the relationship outweighs the apparent advantage of penalties. If trading partners have built up a foundation of trust over a series of transactions, including a penalty clause in a sales contract can be taken as a signal that the seller suspects the ability (or the willingness) of the buyer to pay in a timely fashion. Such suspicion can eat away at the trust between the parties and undermine the relationship.

Our analysis of the survey results identifies strong links between legal activism and use of penalties. It also provides further corroboration of the split between the decisions on including penalties in sales contracts and attempting to collect them when payment is overdue, with the former being infinitely more common than the latter. We developed three types of proxies for legal activism: basic knowledge of the underlying law; use of other legalistic tools; and assessments of the obstacles to using courts.

Knowledge of Substantive Law. The level of familiarity of top managers with key aspects of the law governing business relations is an indicator of the legal activism of the enterprise. Legal literacy is not intuitive; it takes time and energy to attain. As part of the survey, we “tested” respondents (the general director, the sales director, and the procurement director) on their basic knowledge of fundamental aspects of contract law, asking questions about secured transactions law, the priority of the government on the claims of illiquid enterprises, and the prerequisites for contract formation. None of the questions addressed the specifics of the law governing penalties. A composite “test score” was produced for each enterprise, which constitutes a crude measure of the extent to which legal knowledge has permeated the enterprise. This method of measuring legal literacy, albeit crude and imperfect, is vastly superior to using education or seniority as a proxy in an environment where most managers were educated and gained their experience in a country and in a legal and economic regime that no longer exists.

Table 5 documents that enterprises whose managers performed well on our “test” were significantly more likely to use penalty clauses in their sales contracts, although with weak

levels. On business disputing in the U.S., see Keating 1997, and Kenworthy, Macaulay & Rogers 1996.

significance (at the 20% level). On the other hand, “test” scores had no demonstrable effect on the other measures of using penalties. It is plausible that these results reflect differences between the two decision-making processes. Some minimal level of legal competence within an enterprise may be a necessary precondition to putting penalty clauses into at least some of its sales contracts (regression 1). On the other hand, market and relationship factors emerge as critical in deciding how frequently to include penalty clauses (regression 2) or to collect penalties (regression 4). Legal knowledge helps to delimit the options available to enterprises, but does not dictate action in specific transactions.

Litigiousness. The most clear-cut surrogate for legal activism is a willingness to initiate litigation. We asked the legal respondents how often their enterprise had been to *arbitrazh* court as plaintiff in the two years preceding the survey.⁴⁰ We predicted that the use of penalties would be related to the propensity to litigate. Table 6 depicts the relationship vividly. Enterprises that never bring disputes to the *arbitrazh* court are markedly less likely to include penalty clauses, with a mean of 39% of contracts containing such clauses. The mean percentage rises with the propensity to initiate legal action: for enterprises that brought 1 to 5 cases, the mean percentage was 53, whereas for enterprises that brought more than 20 cases, the mean percentage was 68. Table 6 shows that a similar dynamic is apparent with regard to enforcing penalties.

Table 5 serves to emphasize that there seems to be a distinction between legal prowess as a necessary condition to countenance the use of penalties and market and relationship factors as factors determining the frequency of use. Whereas litigiousness is strongly related to decisions on whether or not to include penalty clauses in general and whether or not to collect penalties in general (regressions 1 & 3), it is not related to the frequency of either inclusion or collection for those enterprises that have made these decisions in the affirmative (regressions 2 & 4). This distinction is further accentuated in Table 6. The absence of any upward trend for the subset of enterprises that have included penalty clauses and have collected penalties (lines 3 and 6) confirms that for these enterprises increased use of the courts does not mean that these tactics are used more often.

The lack of a relationship between litigiousness and the frequency of collection of penalties is puzzling. Given that most delinquent customers wait for a court order before paying penalties, we had expected that enterprises who are aggressive in going after punitive damages would likewise be frequent petitioners in the *arbitrazh* courts. Explaining the decision to go to court is difficult in all countries, but is unusually complicated in the Russian case due to the highly politicized nature of legal institutions during the Soviet era (Hendley 1996) and the widespread perception that it is almost impossible to collect on an *arbitrazh* court judgment (Vasil’eva 1997 & 1998; Hay, Shleifer, and Vishny 1996). As the results for regression (4) reported in Table 5 suggest, some enterprises collect penalties without going to court. (There are in fact 20 enterprises in the sample that both collected penalties and did not go to court as a

⁴⁰This covers the period from July 1995 through June 1997.

plaintiff in the past two years.) This is most likely to occur when there is a sustained relationship between the trading partners and the buyer has few alternatives for its goods. In a series of case studies drawn from the surveyed enterprises, Hendley (forthcoming (b)) found that buyers in this position were firmly under the thumb of their suppliers, and would pay penalties if payment were delayed and the supplier forced the issue. As we have noted earlier, however, the key to the behavior is the underlying relationship rather than the legal niceties.

Assessments of the Obstacles to Using Courts. Legal activism can also be affected by the difficulties – real or perceived – of using courts. As we have noted, collecting penalties usually requires a court order and if the enterprise is loath to go to court, then including penalties in sales contracts is a patently empty threat. Since objective data on the qualities of courts is not available, we obtained the subjective opinions of the legal directors about potential obstacles to using the *arbitrazh* courts, such as expense, delay, complexity, confidentiality, judicial bias, and ability to enforce judgments. Enterprise lawyers evaluated the seriousness of each obstacle on a 0 to 10 scale, with higher scores reflecting perception of a greater impediment. The aggregate score for these questions constitutes a crude indicator of the respondent's perceptions of the characteristics of *arbitrazh* courts.

We expected that enterprises with high aggregate scores would be less likely to use penalties. As Table 5 indicates, these expectations were fulfilled to varying degrees. The inverse relationship is strong (1% significance level) with regard to the inclusion of penalty clauses in sales agreements (regression 1). This means that enterprises with misgivings about the *arbitrazh* courts are disinclined to incorporate penalties into their sales contracts. This result alone suggests the importance of the characteristics of the courts to the use of legalistic strategies. Yet the relationship is insignificant with regard to the frequency of including penalty clauses (regression 2) and collecting penalties when payment is overdue (regressions 3 and 4). This requires some comment. The link between skepticism about the courts and reluctance to include penalty clauses would seem to be motivated by the recognition that few customers pay penalties voluntarily. Given that a court order, or a credible threat that one can be obtained, is generally required to make penalties stick, it follows that enterprises that shy away from the courts are hesitant to put penalty clauses in their contracts. The complication arises when we examine the results for collecting penalties. The foregoing rationale would lead us to expect that the inverse relationship would still hold. It does, but not at statistically significant levels, perhaps due to the relative weakness of relationship (4) in general, a weakness which probably reflects the relatively small number of enterprises that pursue punitive damages against trading partners. It may also reflect the fixed cost argument that we have outlined before: once an enterprise is over the threshold of deciding to seek all available remedies, their misgivings about the courts are no longer pertinent.

Relational Distance. Risks of doing business can be reduced through societal choices or through private choices made when transactions are structured. Law is an example of a societal mechanism that reduces risk by creating enduring rules of the game, which need not be negotiated on a deal-by-deal basis. Of course, this “safety net” function of law is most effective

where law is respected and generally obeyed.⁴¹ When choosing whether or not to use law, individual economic actors make their decisions in the context of the surrounding institutional environment and the nature of their relationships with specific trading partners. A relationship can be shaped by a wide variety of factors, both personal and institutional. In some instances, a degree of personal trust develops between managers at the two companies. More often, the two enterprises come to understand how to spur each other to perform their contractual obligations. This calculative trust is rooted in a desire to protect one's own interests rather than in personal ties.⁴² Where enterprises are less well-acquainted with one another, where the relational distance is greater, the need to use legalistic strategies, such as penalties, will be greater.

The pervasiveness of non-payments in business transactions in Russia creates special challenges. Lacking access to reliable information about prospective customers, enterprise managers are hard pressed to assess the credit-worthiness of their trading partners.⁴³ Credit-rating agencies are in their infancy and are not consistently available across Russia. Sellers can take preemptive action by anticipating late payment in the agreement (Hendley, Murrell & Ryterman, 2000; Johnson, McMillan & Woodruff 1999). The inclusion of penalty clauses in their sales contracts as a disincentive to defaults is one example of such an approach. Requiring buyers to pay all or part of the purchase price before shipping goods is another. All reflect the existence of calculative trust between the trading partners.

We sought variables that capture the relational distance between enterprises and their customers. Such variables are likely to be imprecise indicators, since relationships inevitably depend on idiosyncratic factors. One indicator is whether the enterprise is a new firm, created in the 1990's, since it will not have had so much time to build up relationships with its customers. Similarly, an enterprise that has a large share of new customers will have had less experience with its average customer.⁴⁴ There are other, even more indirect, measures. Under the Soviet regime, manufacturing enterprises were separated from the retail sector. They were therefore much more likely to develop relationships with other industrial enterprises than with retail customers. The importance of industrial enterprises in the profile of customers is therefore an

⁴¹The legitimacy afforded law across countries raises the vexing question of the rule of law. A full discussion of the concept is beyond the scope of this paper. For insight into the theoretical underpinnings, see Weber (1967), Fuller (1969), and Selznick (1969). For a discussion of its applicability to the post-Soviet case, see Hendley (1996).

⁴²The distinction between personal and calculative trust was developed by Williamson (1993).

⁴³For insight into the extent of non-payments cases and the rationale underlying the propensity of Russian managers to renege on their payment obligations, see Hendley (1998a & d).

⁴⁴Case studies of a select group of the surveyed enterprises suggest that penalties and prepayment are more likely to be used with unfamiliar customers and that the tendency to use them tends to decline over time as the buyer builds up a track record of complying with its contractual obligations (Hendley 1999 and forthcoming (b)).

indirect indicator of the number of long-term relationships that the enterprise has in its customer base. Similarly, state ownership of an enterprise probably indicates a greater likelihood of stability of operations during the transition era and therefore a greater chance that management has been able to hold onto long-lasting relationships. Finally, there is a variable that captures the small amount of information that we have on whether the enterprise has been able to build personal relationships with its trading partners. When surveying sales directors and purchasing directors, we asked each a series of questions about one specific transaction. Among the questions was one that focused on whether there was any personal (as opposed to purely professional) element to the relationship with the counterpart in the other enterprise. Our variable on personal relationships combines the answers to those questions.

Table 5 includes five variables that act as proxies for inter-enterprise relationships. If our suppositions are correct, then the three of these that tend to be associated with longstanding relationships (state ownership, industrial customers, personal relationships) should be negatively correlated to the propensity to use penalties. The remaining two variables (new firm, new customers), which tend to be identified with less well-established relationships and greater relational distance, ought to be positively correlated to the propensity to use penalties. The results in Table 5 are consistent with our expectations. Since these variables are highly imperfect measures of relational distance, the somewhat weak results for each are not surprising. Taken in the aggregate, however, the results give strong support that relational closeness reduces the propensity to use penalties.

The relative weakness in the results for these individual variables might be because penalties are not necessarily the most effective protection against unknown and perhaps unreliable customers. A more likely explanation is that enterprises are opting for prepayment (full or partial) in lieu of penalties. When compared with penalties, prepayment exposes the seller to much less risk. Even if the total sales price is not pre-paid, the receipt of that portion of the price stipulated in the contract constitutes a signal of the capacity to pay and the good faith of the customer. Often it is sufficient to cover the costs of manufacturing the good. The survey substantiates the widespread use of prepayment.⁴⁵

The importance of pre-payment in dealing with new customers is substantiated by an analysis of the portion of the survey in which we asked the sales directors about the details of one transaction. We asked about the amount of prepayment specified in the sales contract (as a percentage of the final sales price) and the amount actually received by the seller. We found that prepayment in both forms was much more likely to be present when first-time customers were involved. Of course prepayment is costly, in slowing down the tempo of trade, especially in

⁴⁵When asked about the details of a specific transaction, three-fourths of the sales directors reported that they required some sort of prepayment. Of these, more than two-thirds disclosed that the amount of the prepayment was at least as much as the cost of the material inputs needed for manufacture of the good.

Russia where payments are made by bank transfers, which tend to be agonizingly slow.⁴⁶ Thus, prepayment might be much too costly a mechanism for use with existing customers, about whom something is known, but might be necessary when dealing with unknown new customers. This logic provides an explanation for the paradoxical result in regression (4), where the new customers variable is negatively related to the frequency with which penalties are collected. Perhaps, penalties are not collected so frequently from new customers because a large proportion of new customers are never in a position not to pay, delivery being conditioned on pre-payment.

Lastly, our variable on customer arrears might also be an indicator of relationships.⁴⁷ When customers are deeply in arrears, the relationship suffers and may even break down. Not surprisingly, Table 5 shows a significant positive correlation between the level of customer arrears and the inclusion of penalty clauses (regressions 1 and 2). Hence, penalty clauses are used more by enterprises whose customers are more deeply in arrears to them. Such arrears are unrelated to the collection of penalties (regressions 3 and 4). No doubt our respondent enterprises saw little point in going after penalties from customers whose accounts are already long overdue.

Efficient Breach. Legal commentators disagree on whether breach of contract can be justified by the availability of a more profitable alternative. Traditionalists argue that breaches are always wrong and ought to be discouraged (Perillo 2000). Law and economics scholars note that if, after paying compensatory damages, the breaching party emerges as better off, then the breach is efficient. In their view, the law ought to facilitate efficient breaches (Posner 1998; Ulen 1984). They fear that penalties would discourage trading partners from seeking out better deals because they would be liable for both actual damages and penalties if they opt out of an existing contract, thereby raising the stakes. Thus, “a penalty clause may discourage efficient as well as inefficient breaches of contract” (*Lake River Corporation v. Carborundum Company*, 769 F.2d 1284, 1289 (7th Cir. 1985)).

Devising a rigorous empirical test of whether penalties actually affect the propensity to breach would be very difficult, perhaps even impossible. Our survey allows us to shed some light on this question, however. We asked each of the sales, procurement, and legal directors to indicate their relative strengths of agreement with two opposing statements about how contracts should be regarded. At one end of the spectrum was the statement: “Contracts should never be broken, no matter how much the cost of performance to the enterprise;” and at the other end: “Contracts should be broken when doing so serves the interests of the enterprise.” This latter

⁴⁶Checks are not generally accepted in Russia. All payments (other than cash) are made via bank transfer. At the time of our survey in mid-1997, the mean response when asked about time to clear transactions within a region (*oblast'*) was 5.3 days and 10.6 days for inter-region transactions. For an analysis of the variation between regions, see Hendley, Murrell & Ryterman (1999, pp. 445-47, 463).

⁴⁷We asked general directors to evaluate the seriousness of this problem for the enterprise on a 0 to 10 scale.

sentiment reflects an acceptance of the concept of efficient breach. The answers were on a scale from 0 (full agreement with the former statement) to 10 (full agreement with the latter), with intermediate scores reflecting relative strengths of agreement.

Twenty percent of enterprise officials classify themselves as fully in agreement with the view that contracts should be broken when breach is in the interests of the enterprise. The officials split evenly in terms of with which of the two statements they would side. Thus, in Russia in general, contracts are not viewed as inviolate, there being considerable support for the notion that efficient breach is an appropriate approach. This suggests that allowing punitive damages does change the potential for efficient breach.

To further explore the effect of penalties on efficient breach, we added a variable summarizing the attitudes of the sales director on the efficient breach question to the relationships examining the use of penalties. Our hypothesis was that enterprise officials who believed more strongly in the sanctity of contract would be more likely to use penalties, to prevent breaches. This hypothesis is supported by the results for regression (1). This suggests that negative attitudes to efficient breach will lead contracting parties to make their contracts more resistant to breach. Hence, if the goal is to encourage efficient breach, penalties would need to be restricted. This suggests that Dodge (1999, pp. 666-683) might be somewhat optimistic in assuming that the transactions costs of negotiating release from a contract are relatively low. If one party to the contract believes in the inviolability of contract, then it could be difficult even to start negotiation.

Conclusion

Those who would change an institution, scrapping a restriction on freedom of contract for example, face a fundamental problem in predicting the consequences of the change. A crucial piece of information for that prediction is knowledge of how the system's actors would behave under the new freedom. Unfortunately, past observations, before the change, do not provide the pertinent behavioral data.⁴⁸ Nevertheless, insights might be forthcoming from analysis of behavior in other legal systems that have already implemented the institutional change being considered. One important contribution of comparative legal and economic analysis is therefore to provide insight into the consequences of change in one system by using information generated by another.

One clear truth that emerges from the analysis of the survey results from Russia that the decision-making processes for inserting penalties into sales contracts and for going after penalties when payment is overdue are distinct. The picture becomes less clear as we inquire into what motivates Russian enterprises to use penalties at these different transactional moments, which

⁴⁸Hillman (2000) makes use of “behavioral decision theory” to push his analysis beyond the “traditional analysis [which] depends on value judgments about what constitutes effective and fair law and policy” (p. 717). He does not, however, test this theory using empirical evidence.

makes it difficult to make general predictions about the impact of introducing penalties for breach of contract.

We found little support for the common wisdom that enterprises with market power are taking advantage of the less powerful by forcing them to include penalty clauses and then insisting that those penalties be paid if payment is overdue. The survey results also indicate that the availability and use of punitive damages for contractual breach do not translate into an unwillingness to pursue advantageous business opportunities. Put more simply, the use of penalties is not linked to an antipathy for efficient breaches. On the other hand, there is an undeniable link between legal activism and the propensity to use penalties, suggesting that an overall familiarity with legalistic tactics spills over into the realm of remedies. The support for our hypothesis that the use of penalties will decrease when trading partners have a longstanding relationship was tepid at best, although these less-than-robust results may be a reflection of the difficulty of capturing relational distance in concrete variables.

Appendix: The Statistical Analysis

Following a standard approach (Duan et al. 1983), the statistical analysis of the use of penalty clauses in contracts proceeds in two stages. The first step is to examine the factors that influence whether an enterprise chooses to use penalty clauses in any of its contracts, employing the complete sample of enterprises. The dependent variable is dichotomous and therefore probit is an appropriate technique. The second stage analyzes the decision on how frequently to place penalty clauses in contracts, conditional on the fact that the enterprise uses penalty clauses at all. Given the conditionality, this second stage applies only to the subset of enterprises that actually included penalties in their contracts. Tobit is the appropriate technique, with observations on the dependent variable constrained at 100%. It is important to note that we are analyzing a conditional decision (i.e., given some penalty use) in the second stage. Therefore, no sample selection corrections are required, as might be imagined at first blush. For a clear discussion of this point, see Duan et al. (1984).

The analogous procedure is used in analyzing the collection of penalties, again proceeding in two stages. First, we examine the factors that influence whether an enterprise collects penalties at all from customers in arrears, for the complete sample of enterprises. Probit is appropriate for the dichotomous dependent variable. The second stage analyzes how often penalties are collected from customers in arrears, conditional on the fact that the enterprise collects them sometimes. Given the conditionality, this second stage Tobit is appropriate here.

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Table 1: The Uses of Penalties in Russia

| Inclusion of penalty clauses in contracts | | Collection of penalties when payment is overdue | |
|--|---|---|--|
| Percentage of the enterprise's sales contracts that include a penalty for late payment | Percentage of enterprises in the sample including penalties with this frequency | Percentage of transactions in arrears in which the firm collected penalties | Percentage of enterprises in the sample that collected penalties this frequently |
| 0 | 26.5 | 0 | 60.8 |
| 1% to 10% | 13.4 | 1% to 10% | 24.5 |
| 11% to 20% | 4.4 | 11% to 20% | 4.9 |
| 21% to 30% | 2.5 | 21% to 30% | 2.9 |
| 31% to 40% | 0.6 | 31% to 40% | 0.3 |
| 41% to 50% | 2.5 | 41% to 50% | 2.0 |
| 51% to 60% | 0.3 | 51% to 60% | 1.0 |
| 61% to 70% | 1.2 | 61% to 70% | 1.0 |
| 71% to 80% | 1.6 | 71% to 80% | 0.7 |
| 81% to 90% | 2.5 | 81% to 90% | 0.7 |
| 91% to 99% | 2.2 | 91% to 99% | 0.3 |
| 100% | 42.4 | 100% | 1.0 |

Table 2: Relationship Between Use of Penalties in Contracts and Collection of Penalties

| | Percentage of enterprise contracts that include a penalty clause | | |
|---|--|--------------------------------|------|
| | 0 | More than 0 and less than 100% | 100% |
| % of enterprises that collected penalties from customers in arrears | 14.3 | 50.0 | 47.3 |
| Mean of the percentage of enterprise transactions in arrears in which penalties are collected | 3.62 | 9.18 | 8.85 |

Table 3: Relationship Between Use of Penalties in Contracts and Enterprise Characteristics

| | Percentage of enterprise contracts that include a penalty clause | | |
|--|--|--------------------------------|------|
| | 0 | More than 0 and less than 100% | 100% |
| % of enterprises having a legal department | 34 | 49 | 46 |
| Mean enterprise size, measured in number of employees | 874 | 997 | 1034 |
| % state ownership share | 25 | 15 | 19 |
| % of sales in form of barter | 38 | 45 | 45 |
| % of enterprises earning profits | 47 | 37 | 35 |
| % of enterprises losing important customers in the previous year | 38 | 33 | 34 |

Table 4a: Dependent Variables: Definitions and Descriptive Statistics

| Variable | Definition | Mean | Standard Deviation | Number of Obs. | Min. | Max. |
|--|--|--------|--------------------|----------------|------|------|
| (1) Use of penalties in contracts | Dummy variable equal to 1 if the enterprise uses penalties in contracts | 0.735 | 0.44 | 321 | 0 | 1 |
| (2) Frequency of use of penalties in contracts | Percentage of enterprise contracts that include a penalty clause (for enterprises that use penalties in contracts) | 71.669 | 39.58 | 236 | 1 | 100 |
| (3) Collection of penalties | Dummy variable equal to 1 if the enterprise imposes penalties on customers in arrears | 0.392 | 0.49 | 306 | 0 | 1 |
| (4) Frequency of collection of penalties | Percentage of enterprise's customers in arrears that paid penalties (for enterprises that impose penalties) | 19.467 | 25.46 | 120 | 1 | 100 |

Table 4b: Explanatory Variables: Definitions and Descriptive Statistics

| Variable | Definition | Mean | Standard Deviation | Number of Obs. | Min | Max |
|---|---|--------|--------------------|----------------|-----|-----|
| Plaintiff activity | Dummy variable capturing whether enterprise has been a plaintiff six or more times in the last two years | 0.396 | 0.49 | 328 | 0 | 1 |
| Legal knowledge | Score on a "test" of enterprise officials' knowledge of the law | 2.293 | 1.26 | 328 | 0 | 6 |
| Obstacles to using courts | Enterprises ranked the importance of eight obstacles to using the courts, on a scale of 0-10. This variable is a simple sum of the eight scores. | 38.138 | 15.59 | 305 | 2 | 80 |
| Form contract | Dummy variable capturing whether the enterprise has a form contract that is generally used for the sale of its products | 0.905 | 0.29 | 328 | 0 | 1 |
| Emphasis on reorganizing relationships | Dummy variable capturing whether the enterprise director's emphasis on reorganizing relationships with other enterprises is higher than the median value in the sample | 0.460 | 0.499 | 328 | 0 | 1 |
| Simultaneous emphasis on reorganizing relationships and using law | Dummy variable capturing whether the enterprise director's emphases on both reorganizing relationships with other enterprises and using legal institutions are both higher than the median values in the sample | 0.269 | 0.44 | 328 | 0 | 1 |
| Domestic market share | Enterprise's share of the Russian market for its major product | 21.018 | 31.95 | 283 | 0 | 100 |
| Share of new customers | Percentage of enterprise sales to new (since 1992) customers | 48.911 | 29.53 | 327 | 0 | 100 |
| New firm | Dummy variable capturing whether the enterprise came into existence after 1990 | 0.095 | 0.29 | 328 | 0 | 1 |
| Importance of industrial customers | Dummy variable capturing whether industrial enterprises are important customers of the enterprise | 0.381 | 0.49 | 328 | 0 | 1 |
| State ownership | Percentage of enterprise owned by the state | 19.420 | 35.20 | 307 | 0 | 100 |
| Personal relationships in transactions | Dummy variable capturing whether the purchasing director or the sales director responded that a personal element was more important than purely professional contacts in one specific transaction | 0.261 | 0.44 | 321 | 0 | 1 |
| Customer arrears | Dummy variable capturing whether customers are seriously in arrears to the enterprise | 6.799 | 3.17 | 328 | 0 | 10 |
| Attitudes on efficient breach | Score on a scale of 0-10 indicating relative agreement with the views that contracts should not be broken (0) or that contracts should be broken when in the interests of the enterprise (10) | 4.756 | 3.83 | 328 | 0 | 10 |

Note: Dummy variables are equal to 1 if the condition stated in the above definition is true and equal to 0 if it is false.

Table 5: Estimated Relationships Summarizing the Factors Affecting the Use of Penalty Clauses and the Collection of Penalties.

| | (1) | (2) | (3) | (4) |
|---|---|---|--|---|
| Estimated regression relationship examines factors affecting: | | | | |
| | whether penalties are included in contracts | the % of contracts including penalties | whether penalties are collected from customers | % of transactions in arrears in which customers pay penalties |
| Dependent variable is: | | | | |
| | use of penalty clauses in contracts (Table 4a, line 1) | frequency of penalty clauses in contracts (Table 4a, line 2) | collection of penalties (Table 4a, line 3) | frequency of collection of penalties. (Table 4a, line 4) |
| Sample of enterprises used | | | | |
| | all enterprises | enterprises using penalty clauses | all enterprises | enterprises that collect penalties |
| Statistical technique used | | | | |
| | probit | tobit | probit | tobit |
| Use of penalty clauses in contracts | (not included) | (not included) | + 1% | (not included) |
| Plaintiff activity | + 1% | | + 5% | |
| Legal knowledge | + 20% | | | |
| Obstacles to using courts | - 1% | | | |
| Form contract | + 10% | +5% | | -5% |
| Emphasis on reorganizing relationships | | | | |
| Simultaneous emphasis on reorganizing relationships and using law | | +10% | | +1% |
| Domestic market share | | +20% | +20% | |
| Share of new customers | | + 10% | | - 1% |
| New firm | | +5% | | |
| Importance of industrial customers | -20% | | | |
| State ownership | -5% | | - 5% | |
| Personal relationships in transactions | | -10% | | |
| Customer arrears | +20% | +5% | | |
| Attitudes on efficient breach | -5% | | | |

Note: Regional dummy variables are included in all of the regressions. They are jointly significant at the 5% level in (1) (Moscow and Voronezh having higher levels) and at the 20% level in (3) (Barnaul and Ekaterinberg higher, Voronezh lower).

Table 6: Experience as a Plaintiff and Use of Penalties

| | Cases in court as a plaintiff in the last two years: | | | | | |
|--|--|--------|---------|----------|-----|--|
| | 0 | 1 to 5 | 6 to 19 | 20 to 49 | 50+ | |
| | Sample of enterprises | | | | | |
| Percentage of enterprises that uses penalty clauses in contracts | 54 | 79 | 77 | 91 | 87 | |
| | all enterprises | | | | | |
| Mean of the percentage of enterprise contracts that include penalty clauses | 39 | 53 | 56 | 68 | 66 | |
| | all enterprises | | | | | |
| Mean of the percentage of enterprise contracts that include penalty clauses | 73 | 67 | 73 | 75 | 76 | |
| | enterprises using penalties in contracts | | | | | |
| Percentage of enterprises that collect penalties from customers in arrears | 22 | 37 | 45 | 56 | 72 | |
| | all enterprises | | | | | |
| Mean of the percentage of transactions in arrears in which the enterprise collects penalties | 6 | 6 | 9 | 13 | 9 | |
| | all enterprises | | | | | |
| Mean of the percentage of transactions in arrears in which the enterprise collects penalties | 28 | 16 | 20 | 23 | 12 | |
| | enterprises that collect penalties from customers | | | | | |