

Contract Law and Everyday Contracting*

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1 Introduction

The contract is an important tool in business relationships. Contract law, however, approaches contracts *ex post*, i.e. from the viewpoint of court-centred jurisprudence. There is nothing wrong with the court system itself, since an effective court system has to be centralized. In court decisions, therefore, the needs and purposes of the central hierarchical legal system are at least as important as the purposes of the claimant and the defendant, since legal decisions have to be predictable.

Nevertheless, ignoring the role of contracting in business relationships is a serious defect of contract law. Contract law is taught, studied and understood through contracts that have ended up in court, looking at the arguments on which court cases were evaluated, won or lost. A contract, which from the "purely-legal" viewpoint is perfect, can in practice be both a bad contract and a bad tool for business cooperation. The blindness of some academic contract lawyers is so complete that they regard contracting practice as court practice, and for them only judges and attorneys with similar court-centred interests represent practicing lawyers. Business practice and the real actors in contracting are completely forgotten because they do not fit in the court-centred approach of academic contract law. Work on designing and maintaining contractual relationships – and contract management in general – is simply not regarded as a proper subject for legal research, and particularly so when lawyers are involved in such work.

After recognising this, it is understandable that lawyers are not often invited to participate in project management or contract management, but are only hired when everything goes wrong and a battle in the courtroom can no longer be avoided. One reason for the old-fashioned attitude to lawyers as courtroom contestants and even troublemakers is that the traditional approach in law schools is not to teach students how to make good contracts that facilitate business, but to focus on how to make good decisions in court. The traditional education of lawyers does not prepare them for either business contracting or teamwork. Universities educate lawyers to defend and fight for legal rights. Only the legal aspects of each issue are taught as being relevant. Since business nowadays requires flexibility and cooperation skills, law schools should pay more attention to the skills which are actually needed in business. Furthermore, court work nowadays even requires problem-solving and negotiation skills. Judges now need more than the ability to "hand decisions down from above".

The different levels of lawyering are shown in Figure 1. Compared to the figure which has been developed by Thomas Barton and James Cooper¹ and which Helena Haapio presents as Figure 3 in her article *Introduction to Proactive Law: A Business Lawyer's View* in this publication, showing court battles, designing contracts and solving problems outside court as different roles of a lawyer, Figure 1 demonstrates different levels of lawyering as seen in law faculties and as often understood by lawyers. The triangle portrays an iceberg, one where, at least in Nordic legal education, the judge is regarded as being at

¹ Barton, T. and J. Cooper Preventive Law and Creative Problem Solving: Multidimensional Lawyering. California Western School of Law at "www.preventivelawyer.com".

the top. Law schools teach the standpoint taken by the judge, who represents legal decision-making, the noblest level of law. Attorneys take care of the “battles” in courtrooms and apply courtroom contract law. The work done by “fighters” can therefore be illustrated as being at the top of the iceberg below the judge.

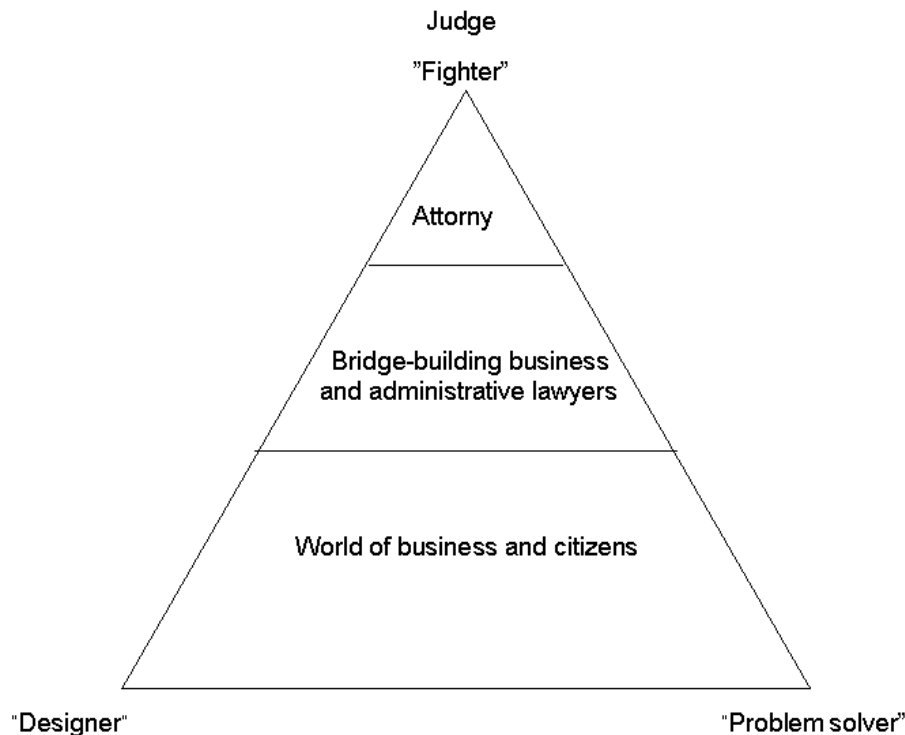


Figure 1. Lawyering as an iceberg (cf. Helena Haapio’s figure focusing on the designer, problem-solver and fighter roles of the lawyer, figure 3 in her article *Introduction to Proactive Law: A Business Lawyer’s View* above, and Salmi-Tolonen’s figure in Haapio et al., p. 286).

Most of the work done by attorneys, however, takes place outside courtrooms. They discuss and plan with their clients, design contracts and solve problems outside court – while of course also preparing for court cases. Below the fighter on the iceberg there is a group of business and administrative lawyers who act as bridge builders between the world of courtroom law and the worlds of business or citizens. Some of them, and some of the attorneys, like it near the top of the iceberg, but others come down below. The more a lawyer adopts a proactive stance, the easier it is for them to descend into the world of business. Even judges can be proactive in their problem-solving work. Designing good contracts and relationships and solving problems as and when they occur is the invisible construction and maintenance work carried out by lawyers. Law schools seldom pay attention to these cornerstones of lawyering because they do not belong to the special world of lawyers at the top of the iceberg, but require good knowledge and skills to move around and understand the worlds of business and citizens.

Since teaching at law faculties is based on research, it is important to widen the scope of legal research, as this widening will then start to be reflected in the

teaching at law faculties. Academic contract law must become alive with the help of empirical studies of business and cooperation between business people. People working in contracting practice do not usually have time to write about, let alone carry out research on their own work. Unfortunately, cooperation with universities does not always work either. Universities are more interested in judges and attorneys with interests similar to those of law professors and other legal scholars. Despite these roadblocks, we have succeeded in establishing a group of practising and academic lawyers in Finland who are interested in contracting. We have written - and continue to write - books, we plan courses and support each other. Our work has become known as the *Proactive Law Movement*, and has led more recently to development of the *Nordic School of Proactive Law* (cf. Helena Haapio's Introduction to Proactive Law in this publication).

This paper focuses on how proactive law can be introduced into legal research and presents an empirical study as an example of the attempt to widen the scope of legal research so that it becomes more useful in the field of business contracting.

2 Proactive Contract Law – Law in its Contractual Context

2.1 *The Roots of Proactive Law*

Because the Finnish proactive movement started in the corporate arena,² proactive law focuses on multi-professional teamwork between lawyers, engineers, sales and purchasing personnel, people working on projects, with contracts or involved in quality and risk management. The roots of proactive law are in preventive law, a field which Louis Brown started in the United States in 1950 with his book *Preventive Law*.³ Louis Brown worked as both an attorney at law and as a professor of law. As an attorney, he realized that with better planning and good advice from their lawyers, his clients could have prevented most of the problems they experienced. Proactive law shares the same approach, but differs from preventive law because of its emphasis on the client and multi-professional teamwork, and on promoting successful business - rather than focusing on the lawyer and on the prevention of legal problems and lawsuits. In proactive law, the focus is on the very early roots of problems and opportunities which need to be identified before anything is labelled "legal". The difference between preventive law and proactive law can be demonstrated with the figure borrowed from preventive medicine and developed further by Helena Haapio⁴.

Preventive law research would not have emerged without realistic jurisprudence, which emphasizes the gap between "law in books" and "law in

² The main initiator of the proactive contracting movement is Helena Haapio, who writes about the first steps in the Finnish proactive contracting movement in the introduction to this publication. See footnotes 14, 16 and 17 in Haapio's introduction.

³ Brown, L., 1950, see also footnote 3 in Helena Haapio's introduction.

⁴ See Helena Haapio's introduction, Figure 1.

action”. However, even for most legal realists in the United States and Scandinavia, legal practice represented the work of a judge.⁵ Even if the court-centred approach continued to dominate legal studies, realistic jurisprudence, however, has started to pay attention to applying law in practice.

American common-law based research seems to have been more willing to understand that in contracting, it is also important to focus on the real actors. Common law, which regards law as being created in practice, is less centralized when compared to the strong emphasis in civil-law countries on statutes which are created from above and enforced on legal subjects. Empirical studies of law inspired by American realistic jurisprudence also produced empirical studies of contracting. Stewart Macauley’s article *Non-contractual Relations in Business* (1963) launched the idea of the need for studying contracting in real life. It also showed what a relatively-minor role business people often allocate to law in their business relationships. Unfortunately, Macauley’s findings that the law did not seem to have any significant role in contracting practice appeared to frighten lawyers back to their own corner of court-centred jurisprudence.

2.2 *Extending and Reforming Court-centred Contract Law*

Ian Macneil, who dedicated his career to developing a theoretical basis for empirical studies of contracting, developed the relational contract movement.⁶ A relational contract is an attempt to reform contract law in more-flexible direction by extending courtroom decision-making to cover the contractual relationship itself. As a movement for the reform of court-centred contract law, the relational contract has not been particularly successful. Its failure is understandable. Too much flexibility in court decisions poses great dangers for legal predictability. The relational contract, and all the other movements attempting to change court-centred law into something else, have chosen a problematic path. The court-centred *ex post*-oriented law and the *ex ante* business approach have different objectives, purposes and values. They cannot be mixed into something which no longer serves the interests of either party. Relational contract has however proved to be fruitful through its emphasis on the planning of contractual relationships and preventing problems from occurring.⁷

⁵ By legal realists I refer to such early American realists (instrumentalists) as Karl Llewellyn, John Dewey, Roscoe Pound, O.W. Holmes Jr. and Lon Fuller. The leading figures in “Scandinavian realism” are the Swedes Axel Hägerström, Viktor Lundstedt and the Dane Alf Ross. Their legacy is still visible even if the movement itself does not exist any longer. In Scandinavian countries, their legacy continues in the attitude towards continental-based legal concepts and systematics, both of which are regarded as simply practical tools for helping to teach and understand the law. Concepts have only a minor functional role. Empirical studies, however, are not common in present-day Scandinavian legal studies.

⁶ E.g. Macneil, I, 1978. A recent collection of Ian Macneil’s production, including an excellent article concerning his influence in the U.S. and the U.K., is D. Campbell (ed.) 2001.

⁷ See contract planning parts of the textbook I. Macneil and P. Gudel 2001.

Relational contract has encouraged some legal scholars to make empirical studies and analyse contractual behaviour. Many of these scholars emphasize that especially in long-term contracts, extra-contractual relationships matter. For contract managers and people working with contracting in a business context, this fact is self-evident, but for academic lawyers, this is not the case. Different aspects of contractual relationships have inspired different scholars. Hugh Collins, who has attempted to include relational ideas into mainstream contract law, has emphasized the importance of social conditions.⁸ In Finland we have seen similar kinds of attempts to renew contract law by trying to include the contractual environment and the values held by the actors into the sources of legal decision making.⁹

2.3 *Transaction Cost Economics (TCE) – a Multidisciplinary Approach using Economic Logic*

Macneil's emphasis on reciprocity in contractual relationships has collected many admirers and his ideas have often been used for a variety of purposes. From the viewpoint of business contracting, there is an interesting connection between the relational contract and transaction cost economics (TCE). Oliver E. Williamson used the basic concepts of the relational contract: the classical, neoclassical and relational contract¹⁰ and related them to the economic institutional forms of the market, bilateral and trilateral governance and unified structures. Market governance is typical for non-specific, one-time transactions between partners who do not know each other and who are not going to establish a long-term business relationship. Market governance is related to classical contracting with simple rules that leave room for freedom of contract. Neo-classical contracting attempts to include flexibility by adding contract clauses for adjustment to changed circumstances. Emphasizing the obligation to cooperate or mitigate is typical of neo-classical contracting, which typically relies on arbitration and other third-party-based assistance. Williamson calls this "trilateral governance". Relational contracting, which is based on mutual trust, is typical in long-term relationships and is either handled through bilateral governance between the parties themselves, or via unified structures which also exclude outsiders.¹¹

Williamson's hypothesis is that the various types of contract should be "matched" to different types of transaction according to the economic conditions of *asset specificity*, frequency, and uncertainty. TCE studies have placed a special focus on *asset specificity*. Investment in transaction-specific assets unites the parties, making adaptability and continuity important and

⁸ Collins H., 1996.

⁹ Juha Karhu (former Pöyhönen) has developed so-called new-contract and property law resembling Macneil's relational contract, but does not mention Macneil as his inspiration. His ideas are rooted in Finnish analytic jurisprudence and the social civil law developed by Thomas Wilhelmsson. See Pöyhönen, J. 2001.

¹⁰ See footnote 5; Macneil, I., 1981.

¹¹ Williamson, O.E., 1985; Williamson, O. E., 1996.

reducing the temptation to engage in opportunistic behaviour. A specific asset can be site specificity, when for example successive stations are located close to each other to economise on inventory and transportation costs. Unified ownership is the predominant response to site specificity. *Physical asset specificity*, for example, is specialized dies that are required to produce a component. If the assets are mobile and the specificity is attributable to physical features, market procurement may still be feasible by concentrating ownership of the specific assets in the purchaser and putting the business up for sale to the highest bidder. *Human asset specificity* arises in a learning-by-doing fashion and favours employment relationships over autonomous contracting. Common ownership of successive process stages can be predicted as the degree of human asset specificity increases. The fourth type of asset specificity is *dedicated assets*, representing a discrete investment in generalized production capacity that would only be made when there is the prospect of selling a significant quantity of products to a specific customer. These involve expanding existing plant to accommodate a particular purchaser.¹² The fifth type is brand-name capital. The sixth is temporal specificity, which is technological non-separability, a kind of site specificity in which rapid response by on-site human assets is vital.¹³

Williamson's TCE has been tested in empirical studies of long-term contracting¹⁴ including the international iron-ore, coal-industry, natural-gas and other markets for natural resources.¹⁵ TCE can be defined as a *law and economics* approach which, unlike many other approaches representing law and economics, has no interest in decision making in courts but focuses on private governance.

Applying the *ex ante* approach of TCE, which emphasizes that transaction costs are of importance in business contracting, is a fruitful approach for research into proactive contracting. Since legal studies cannot offer an *ex ante* approach, we must turn to other sciences. Empirical studies alone have not yet been able to reform or extend the theory of contract law to contractual practice¹⁶. The approach employed in TCE is closer to the logic employed in business than any approach developed within contract law itself.¹⁷ It must however be admitted that the TCE approach which emphasises savings in transaction costs does not always cover all aspects of contracting. When

12 Williamson, O.E, 1985, 52-106.

13 Williamson, O. E. 1996, 105-106.

14 Klein and Shelanski's (1993) ten-year-old article is an analytical review of empirical TCE. According to them, there have been both quantitative and qualitative studies, econometric analysis and studies in different industrial branches as well as studies focusing on particular functional models such as vertical integration, hybrid models, long-term contracts and informal contracts.

15 Daintith, T., 1987; Joskow 1985, 1987, 1988, 1990; Crocker and Masten 1988, Goldberg and Erickson 1987; DeCanion and French 1993.

16 Empirical scholarship, however, appears to be gradually gaining strength. See eg. Korobkin 2003. For example, the annual meeting of American law schools in 2006 is dedicated to empirical studies in law. In Finland, empirical studies have flourished outside law schools, especially in criminological matters.

17 Nystén-Haarala 1998

exploring in depth the social, institutional and organisational contexts in which contract behaviour in different countries is embedded, research has been able to reveal how trust and cooperation are sustained by a variety of relational influences in the contractual environment.¹⁸ This ‘embeddedness’ discussion, which attempts to emphasize the behavioural aspect of TCE, is important for proactive law, since its sociological approach emphasizes the connection between law and organization and management studies which is crucial in multi-professional contract management. The Finnish proactive law movement has emphasized project management and knowledge management as well as organizational studies¹⁹. TCE is closely related to organizational studies, although learning aspects, a subject on which Argyres and Mayer have recently focused, have been neglected in TCE.²⁰ Some TCE scholars have also been able to show that in spite of previous empirical studies regarding the marginal importance of law in business, the use of formal agreements and the presence of legal enforceability as a form of security are highly compatible with relational contracting.²¹

3 Mixing Multidisciplinarity and Law

In addition to the multidisciplinary TCE and the emphasis on its different aspects, even cultural studies can contribute to understanding contractual relationships. In the social sciences, the Birmingham school applied anthropological methods when studying attitudes among working-class schoolchildren.²² Methods used in anthropology have also been applied in the field of comparative law.²³ Participatory methods have also been used when

¹⁸ Deakin, S. and Wilkinson F, 1996; Deakin, S., Lane, C. and Wilkinson, F., 2001.

¹⁹ Kerttuli Visuri and Soile Pohjonen’s joint article *Proactive or Reactive? Project Management and Contracting*, (Mordent 2004 Conference, Drum) focuses on project and knowledge management. Vaula Haavisto applies organizational studies in her articles e.g. *Sopimustoiminta verkostoissa*, in Soile Pohjonen (ed.) *Ennakoiva sopiminen*. WSOY lakitieto Helsinki 2002 and together with Helena Haapio ”*Sopimusosaaminen: Tulevaisuuden kilpailutekijä ja strateginen voimavara*”, in *Yritystalous* 2, 2005, p. 7-16. The Finnish Proactive Law Movement is also interested in law and language and arranged the “*Future Law, Lawyering and Language*” conference in Helsinki in May 2002 with professors Heikki Mattila and Tarja Salmi-Tolonen.

²⁰ Williamson 1999. Kyle Mayer and Nicholas Argyres have studied the learning aspects of contracting (Mayer-Argyres 2004). The Finnish proactive contracting movement is also expanding its empirical studies of learning how to contract with its latest research project “*Corporate Contracting Capabilities*”, which is funded by the *Liike2* research programme of the Academy of Finland (2006-2009) and the Tekes *Business Research* programme. Tekes is the Finnish Funding Agency for Technology and Innovation (2006-2007).

²¹ Arrighetti, et al. 1997.

²² Willis, P., 1978.

²³ Rouland, N., 1988. Comparative law has always cherished the idea of the importance of taking into consideration the environment in which law works, even though in practice, comparisons of legal dogmatism dominate. Zweigert and Kötz’s *Introduction to Comparative Law* 1992 is a typical example of the “do as I say not as I do” research policy in comparative law.

studying business organizations to establish how an organization learns and how it can develop in a more-efficient direction. Professor Yrjö Engeström's research groups have applied methods that involve observing and interviewing as well as self-analysis by corporate personnel.²⁴ These methods can also be applied to contracting. It should also be borne in mind that the further we move from our own culture, the more certain it is that we will face cultural differences in contracting.

Rejecting a professional approach that is too narrow in terms of both business practice and contracting studies is the only way to develop an understanding of successful business and how it should be promoted. The proactive contracting group has not selected any special theory to support its primary objectives. As long as a lawyer can understand the need for an *ex ante* approach and work together with people using skills other than those connected with legal contracting, he or she can work proactively. While this sounds simple, it is not always so in practice. From the viewpoint of academic contract law, one problem is that studies of contracting practice are not covered by a legal theory and are therefore regarded as "not scientific enough". Scholars who do not follow the mainstream are not accepted as full members in academic circles. Academic lawyers have to be made aware that law exists outside court cases and legal regulations. While proactive law can never be captured by court-centred legal theory, it should be accepted as research that focuses on contracting from an economic and organizational point of view. Proactive law has only just started to create its own research tradition.

4 Trading Roundwood in a Constantly-Changing Legal and Business Environment

4.1 Background, Objective and Method used in the Study

To provide an example of a multidisciplinary study of proactive law and contracts in action which applied the qualitative interview methods employed in cultural studies, I now present my own study of trade in timber between Russia and Finland. The aim in this study was to map the kinds of contracts and contracting methods that are used. The study looks for answers to questions such as: In what way do timber-supply contracts promote business? How is the governance structure chosen and why? How are risks managed? What is the role of law in roundwood trade? Can contracts be improved?

Finland's forest industry is heavily globalised and companies operating in the sector are multinationals. The main sources of raw material are still Finnish forests. Growing markets have, however, required that timber be imported, and currently more than one fifth (21% in 2003) of the wood processed by the Finnish forest industry comes from outside Finland. Since the same boreal

²⁴ Engeström 1987

forest belt covers both Scandinavia and northern parts of Russia, it is quite natural that most of the imported timber (81% in 2003) comes from this region²⁵

Finnish forest companies also imported timber from Russia during the Soviet period. At that time, the framework for the quantities and the value of imports were always the subject of negotiation and included in the protocols of bilateral exchange between the two countries. When the bilateral state-trading system collapsed with the demise of the Soviet Union, Finnish companies were forced to find new private partners. Some of the current trading partners were also involved in forestry activities during Soviet times, but people completely new to the business also appeared. Some of these were in good political positions which enabled them to lease state forests. There are also agents buying and selling timber on the Russian side. In some Russian regions, harvesting firms are organized under huge holding companies that handle timber sales for the whole region. Small entrepreneurs are typical in regions such as the Karelian Republic. The biggest Finnish importer is Stora Enso, UPM-Kymmene and Thomesto/Metsäliitto are in joint second position. Some of the roundwood sourced by the Stora Enso importing unit goes to the concern's Swedish factories. Thomesto also purchases timber for its Swedish and Norwegian mills. All the big multinationals have their own purchasing units which seek to secure a constant supply of roundwood for factories in Finland. These units are organized in different ways, especially in terms of the degree to which business is established in Russia. It should be mentioned that as there are some independent Finnish agents, all roundwood supplies are not arranged within the internal network of the big Finnish multinational companies .

The interview method used in the study is partly structured. Four Finnish purchasers and eight of their Russian suppliers were asked the same questions in an interview that lasted about an hour. The interviews focused on the content of contractual clauses and how the parties to the contracts understood these. The business environment was also mapped, as was the way that business partners viewed their business relationships. The Finnish purchasers interviewed came from the three multinationals already mentioned and from one medium-sized locally-based company which did not wish its name to be published. The Russian partners came from the Karelian Republic, the Leningrad region and the Arkhangelsk region²⁶, and are mostly companies that rent state-owned forests and harvest them. Renting periods range from five years to the maximum of 49 years allowed by the current Forest Code of 1997. Some of the interviewed Russian companies were traders who buy and sell roundwood.

Wood is also purchased from the Novgorod, Vologda and Moscow regions. Transportation costs mean that Siberia is too far away. Russian pulp and paper mills in the Karelian Republic may, however, also transport wood from Siberia

²⁵ METLA, *Metsätalastollinen vuosikirja 2003* (Annual Statistics of Forests, The Finnish Forest Research Institute)

²⁶ Interviews were carried out in the spring of 2004 in St. Petersburg, in the autumn of 2004 in Petrozavodsk and in the winter of 2005 in Arkhangelsk. Interviews in Finland were also carried out between spring 2004 and spring 2005. I have also used material from interviews made during the same period in Russian pulp and paper mills in the Karelian Republic and the Arkhangelsk region when I was mapping the business environment and markets for roundwood in Russia.

because of the double pricing system used by the Russian railroads. Wood for use in Russian mills is transported at a lower cost than wood that is to be exported.

Two of the Finnish multinationals have already purchased some harvesting companies in Russia. They also have terminals for transporting roundwood. Establishment in Russian markets is a slow process, since the multinationals have purchased only a few sawmills and plywood factories. Among Russian companies, however, vertical integration is quite strong in some sectors. A few holding companies controlling local pulp and paper mills also control harvesting companies in the Arkhangelsk region, which makes this region a hard market for outsiders. While economic growth has made the forest sector profitable, it has also resulted in a wave of hostile takeovers among pulp and paper companies. The battle between different Russian holding groups for ownership of enterprises has been going on for some years.

5 Relational Aspects and Trust Building

Interviews with purchasers and suppliers of roundwood proved that many of Macauley's findings are still valid, at least in business involving simple goods such as raw materials.²⁷ The relational method of contracting, which sees maintaining good business relationships as important, appears to work quite well in markets where suppliers and purchasers know each other and the reputation of newcomers is easily checked. Gaining and maintaining a good reputation and trust appear to be crucial matters in business relationships. In addition to relational contracting, some purchasers emphasised risk management and regarded the contract as a safeguard if something goes wrong. The latter approach utilizes the opportunity to make suppliers compete with each other to a greater extent and pays more attention to risk management when designing contracts than the relational contracting approach, which emphasises the maintenance of good relationships above all else. It does however seem that the difference is only a question of the degree of emphasis and not a clear distinction in operating methods.

There is usually a model contract which is adjusted to match the interests of both parties to the contract. All the contract terms except prices and quantities are included in this framework model. If the seller is not a long-term business partner, the terms of the contract are more carefully negotiated. Between long-term partners, it is usual for only the prices, quantities and times of delivery to be negotiated. While natural forces can sometimes make it difficult to fulfil the agreed amounts, differences between the agreed and fulfilled quantities do not seem to constitute a serious problem for purchaser. The delivered amounts are simply adjusted in the long run without resorting to legal remedies provided by the contract. According to both purchasers and suppliers, there are seldom such shortages in quantity that the amount notified by a supplier would differ from the amount examined by the purchaser.

²⁷ See footnote 4.

Finnish purchasers of roundwood appear to be quite popular among Russian suppliers. Because prices were treated as trade secrets in the interviews, it is difficult to say whether prices have anything to do with this. Both purchasers and suppliers, however, emphasized flexibility, which long-term relationships make possible. Even if the improved economic situation in Russia has reduced the extent of problems with non payment and delays in transferring funds, Finnish purchasers have the advantage of their reputation as reliable payers. One purchaser explained that accepting a proposal that payment be made earlier than originally agreed can engender gratitude, which shows itself in improved service and a willingness to show flexibility in the future.

The choice of suppliers could also amount to human asset specificity, which according to TCE might in the long run lead to unified structures, i.e. purchasers investing in enterprises representing reliable suppliers. When applying TCE explanations, it can however be mentioned that Finnish purchasers have avoided the problem of getting themselves tied too closely to their suppliers. In studying the shipping of bulk goods in the United States, Pirrong found a phenomenon which Masten, Meehan and Snyder named *temporal specificities*.²⁸ When a refinery makes a contract with a particular transporter of bulk goods, the capacities of both the refinery and the transportation company become specific assets. Even small delays in delivery may cause huge losses to the refinery as well as the refinery denying taking a complete delivery causes losses to the transporter. Finnish purchasers have avoided temporal specificities by keeping an amount of wood in storage that allows them to balance out peaks in supply or demand. The power balance between suppliers and purchasers is now totally different to how it was in the Soviet period, when roundwood appeared at the border between Finland and Russia in quantities - and a variety of qualities - decided by the supplier.

6 Methods of Ensuring Quality

Quality appears to be a source of problems. Purchasers sometimes claim that the quality of shipments is lower than agreed and the suppliers disagree. Roundwood is merchandise which cannot be returned to the seller. Examination of the goods takes place either at the sawmill or at a pulp factory, both of which are the final destinations for roundwood. Sometimes, goods may be examined at the purchaser's terminal in Russia. The only small-scale purchaser interviewed works near a border crossing which is closed for ordinary transportation shipments. This purchaser arranges transportation himself and the wood is collected from the Russian side of the border. The positive side of being forced to arrange transportation is that the purchaser does not have to take goods which are of the wrong quality or spoiled. When goods are checked at the final destination, the purchaser informs the seller of the results of his examination and transmits payment based on this information. If the seller disagrees, the only way to prove that the purchaser is mistaken is to travel to where the

²⁸ Masten, Meehan and Snyder 1991; Pirrong 1993

merchandise is situated and demand a new inspection. Most sellers do not bother to travel, but some do use official merchandise inspectors in Finland for this double checking. It seems that in this respect, there is no absolute trust between purchasers and suppliers. Mistakes can happen on both sides. The good relationship between supplier and purchaser does not extend to all units in a large corporation. One supplier even suspected that he could be being cheated in a systematic manner.

The quality of roundwood is a complicated issue. Purchasers have defined quality standards for roundwood used for different purposes and Russian quality standards differ. Such quality requirements favour relational contracting even in trade which - for an outsider - might appear to involve goods which are rather simple. It is easier to continue business relationships with suppliers who already know the quality standards and follow them. Specialising in particular quality standards could in some cases resemble TCE's dedicated assets.²⁹ Some suppliers specialise in selling to Finnish purchasers, who even recommend them to one another.

7 Terms of Contract and the Settlement of Disputes

In practice, terms of contract other than price, quality and quantity do not appear to be very important. The *force majeure* clause is one that is usually carefully negotiated, but not applied in reality. Late deliveries are tolerated, since the merchandise is not easily damaged in transit. Difficulties in border control and with customs clearance seldom ruin a delivery. Purchasers can solve usually problems caused by late delivery by keeping enough wood in storage to guarantee a supply of wood to the factories. In most cases, Russian wood appears to be used to fill the gaps in domestic supply, although some factories situated close to the border already use mainly Russian wood in their production.

In addition to the terms concerning delivery, other terms are important even if they are not discussed with each individual purchase but remain terms of the contract which "the parties do not bother to read." Environmental issues are risky. If it is revealed that the wood has been cut from a protected area, the purchasing company may suffer considerable losses in the Central European market, where nature protection is important. In 1997, for example, when environmental organizations informed the media that a Finnish company had exported wood originating from protected ancient forests in the Karelian republic, Finnish paper products were subjected to a consumer boycott in Germany.

Purchasers attempt to avoid new environmental scandals using several methods., of which knowing the supplier is one. Certificates of origin are required from suppliers, and purchasers also include a clause according to which the supplier is liable if the origin of the purchased roundwood turns out to be different from that shown on the certificate of origin. Transferring legal

²⁹ Williamson 1996.

liability to the supplier does not, however, save the multinational company doing the purchasing from moral liability, which it will anyhow have to carry in the eyes of western consumers and environmental activists.

Illegal logging is a problem in Russia and complete protection from being caught trading in illegally-logged roundwood is impossible. According to statistics issued by the Russian Ministry of Natural Resources, 716,000 cubic metres of forest were illegally logged in 2003. The corresponding figure from the World Wildlife Fund is 11.2 million cubic metres.³⁰ The differences between these figures result from the undefined concept of illegal logging. The figures provided by the WWF originate from Russian environmental organizations. The Russian authorities can regard failure to pay taxes or the making of a small technical mistake in customs documents as illegal logging. In principle, logging without a permission should be difficult. Environmental organizations, however, claim that in some cases illegal logging takes place under the protection of armed gangs and with the consent of the local authorities. Sometimes illegal logging takes place around an area which is being legally harvested³¹. The suppliers of roundwood who were interviewed said that illegal logging usually consists of illegally extending a logged area outside the permitted area. Because permission exists, illegally-logged lots can be delivered to any purchaser in spite of their having a certificate of origin. Lawyers interviewed in Russian pulp and paper mills said that they are considering including a similar contract term in their supply contracts that transfers liability for illegal logging to the supplier.

Some purchasers also use other sanction clauses in their contracts, but rarely resort to these even in cases of delay or defective quality. The reason is the already-mentioned strategy of keeping enough roundwood in storage. Not resorting to sanction clauses can also be used as a gesture of goodwill. Often the explanation given by a supplier is reasonable. Especially during rainy summers, it may be difficult to fulfil agreed quantities.

None of the purchasers had a clause in their contracts relating to possible consequential loss. They did however assume that even without such a contractual clause, the seller should cover any consequential losses. According to one company, they have even made a supplier pay consequential damages in some exceptional situations. If the UN Convention on the Sale of Goods is applied, the purchaser is entitled to damages for the whole loss, including lost profit (Article 74 of the CISG). While the CISG does not differentiate between direct and consequential losses in the way that Nordic Sale of Goods acts do, only foreseeability is required from the seller's side. There were no clauses for choice of law in any of the contracts. This means that according to the rules of private international law in both Russia and Finland, the starting point for disputes concerning a contract is law in the seller's country. It is therefore the CISG, which is applied in the form in which Russia has ratified it. The secondary legislation applied for issues which are not covered in the CISG is Russian law.

³⁰ Rosbalt News 12.7.2003; Agence France Press 4.4.2003.

³¹ *Kratkii obzor* 2003.

Relational wood-supply contracts keep long-term transaction costs low. Maintaining good business relationships is especially important for suppliers, but it is unusual for large purchasers to "misuse" their position and change their long-term suppliers in order to make short-term gains. Only constant deficiencies in quality or quantity are likely to cause the complete termination of a business relationship. Litigation and arbitration appear to be very rare methods for solving disputes. Russian partners appeared to be more often involved in arbitration or litigation with their own government and domestic trading partners than with Finnish purchasers.

Only one of the purchasers interviewed had ever been involved in arbitration with a Russian roundwood supplier. This happened in the early 1990s when the purchaser was looking for new suppliers. In statistics provided by the Moscow Chamber of Commerce and Industry, one dispute in 2003 involved a Finnish purchaser of roundwood, but this organisation was not one of the interviewed companies. One of the purchasers interviewed offered the opinion that "It's the contracts drafted on a matchbox in a petrol station in Viborg which end up in litigation or arbitration". All the interviewed companies had different clauses concerning dispute resolution. Some had an arbitration clause specifying the rules of the Moscow Chamber of Industry and Commerce or the Helsinki Chamber of Commerce. Some used litigation in the country of the defendant. One of the purchasers said that their concern's legal department would have liked to swap the Moscow Chamber of Commerce for the more-neutral Stockholm Chamber of Commerce. The purchasing unit did not agree, since Stockholm is much more expensive than Moscow and because choosing Moscow was also a gesture of trust. The choice was also regarded as a question of principle, even if the company had never resorted to arbitration – "And never will, if it depends on me" as the purchaser put it. Disputes are solved through negotiations between the parties and arbitration is only a secondary method of dispute settlement. Applying TCE, bilateral instead of trilateral governance is used.

An interesting coincidence is that the company, which had been involved in a legal dispute at the beginning of the 1990s was the only company in which a Finnish lawyer is always involved in contracting. It is also the company that emphasises risk management and contracts as the last resort when solving disputes. In other words, as Shelanski and Klein have shown³², disputes in the past lead to more complete contracts. Even in this company the lawyer worked as an outsider checking contracts before they were used. He viewed his own role as a solver of legal problems, which luckily do not occur in the roundwood trade. In other companies, in-house legal departments sometimes checked the contracts. The attitude that people working in the field adopted towards lawyers was not at all flattering. Contact with lawyers was avoided, and attempts were made to solve problems with suppliers without informing the legal department at any stage. The explanation given for this way of working was that lawyers tend to turn problems into legal issues, which in practice they seldom are. The ability of lawyers to understand business was not considered very reliable.

³² Shelanski and Klein 1995.

8 Effects of the Special Economic and Social Environment of the Russian Market on Contracting

Even if Finnish lawyers are not involved in the contracting process, a Russian lawyer checks most contracts. The reason for this is that the Russian state controls contracting in many different ways, and a contract is also understood as a tool for control by the Russian authorities. Contracts are not only written for the contracting parties, they will also be checked by the customs and tax authorities, and by the banks. Russian contract law requires that both export contracts and most domestic contracts are in written form. Since the customs authorities will check the quantity of any goods crossing the border, any changes in quantities or prices must also be made in written form.

In the former Soviet Union, contracts were administrative tools used to control the fulfilment of state plans. This way of thinking appears to have some effect even nowadays, in spite of the fact that the Russian Civil Code proclaims freedom of contract. Many models for different types of contracts are published, and their only typical feature is that they take account of nothing more than the legislative requirements. Relying on these models will not produce a good business contract. Many academic lawyers understand their own role as being that of creators of rules for business enterprises. Non-mandatory legislation is understood as a tool for unifying the country and creating legally-acceptable norms for “illegal” business. Non-mandatory norms are therefore a stronger source of law than actual trade usage³³. There is not even a consensus on whether exemption from any law, even non-mandatory, can be achieved by using a contract. Unfortunately, circumstances such as these discourage the use of contracts as tools for the transfer of information and guidance between contracting parties.

The attitude adopted in Russia towards business is quite suspicious. It is regarded as a field for either criminal or at least dishonest activity. The reasons for such attitudes partly stem from Soviet society in which private business was illegal and enrichment was immoral. The negative attitude is also a result of the widespread economic crime which resulted from badly-planned privatisation and economic reforms in the 1990s. Privatised state property ended up in the hands of a few so-called *oligarchs*. Another source of wealth for these *oligarchs* was budgetary funds channelled by the Central Bank of Russia and international financial aid, which was quickly transferred to private accounts.³⁴ Dishonesty and corruption maintain distrust in business activities and has also led to legislation which is too strict and overcomplicated, and which cannot be adequately enforced. Criminal activity flourishes in a corrupt and arbitrarily-functioning system in spite of strict rules. Unfortunately strict rules can harass and complicate honest business endeavours. Richard Rose, who has studied

³³ Braginskii- Vitryanskii 1999.

³⁴ Stiglitz 1998; Kits, Novitskov, Stroganov 2001. Stiglitz was the main economist of the World Bank and probably one of those who made public the misuse of international aid in Russia. Kits, Novitskov and Stroganov are former deputies of the Russian State Duma (the lower chamber of the Russian parliament).

Russian attitudes towards legislation, calls this the problem of antimodern society.³⁵ By the term “antimodern” he refers to a society which has many formal organizations and legal rules that resemble those in a modern society, but which function in an arbitrary and unpredictable manner. In an antimodern society, personal relationships and good networks are more important than official institutions. The weaknesses of an antimodern society can be exploited by criminal activity. Using antimodern informal institutions leads to higher transaction costs and encourages corruption and economic crime.

Finnish purchasers, however, have managed to transfer most of the risks associated with this antimodern society to their Russian suppliers. Struggles with the customs authorities are usually handled by the transporting company, which is Russian in an increasing number of cases. The most-common form of transportation is rail, followed by road transport supplied by a growing number of Russian transport and shipping companies. Banks receiving payments in foreign currency should according to Russian legislation inform the tax authorities of any disparities. The tax authorities, who make many mistakes because of low levels of professional skill and the fact that bonuses are earned on the basis of the amount of taxes collected, are a problem that the Russian partners have to cope with. On the other hand, Russian lawyers say that tax disputes are common and easy to win because tax legislation and the courts not only force the tax authorities to prove their claims, but also favour the taxpayer in unclear situations. This undeniable sign of the improved rule of law, however, raises transaction costs and increases insecurity in business. Add in the facts that foreign business is treated with suspicion and that exporting raw materials instead of final products from Russia is regarded as having a negative effect on the Russian economy, it is understandable that multinational forest companies are not eager to invest in Russia. Investing in logging companies (i.e. vertical integration) could be a strategic investment in the long term. Problems resulting from an antimodern society are, however, easier left to the Russians. Investing in logging companies could lead to difficulties. It seems that investing in logging companies is also a strategic investment in the domestic Russian forest sector. It is a way to gain power and control, not necessarily a way of saving transaction costs.³⁶

Forest legislation is also a factor that influences the roundwood trade. The present federal forest code stems from 1997 and was a subject of dispute when it came into force because it resulted in the federal centre gaining power from the regions. The Russian federation owns the whole of the Russian forest fund. All valuable forests and forests which can be used for forestry are included in the forest fund. According to the code, each region receives 60% of the logging tax and the federation receives 40%. Taxes raised from permissions to use natural resources are an important source of funds for regional budgets. The draft of a new forest code is now in Russia’s federal parliament but it has also been disputed for many reasons. The hottest dispute appears to be whether the forest should become privately owned. Most of the suppliers of roundwood interviewed did not want to allow private ownership because it would lead to

³⁵ Rose 2000.

³⁶ Spiller 1985.

the rich *oligarchs* investing in forestry. They preference was that private ownership would only be for those who had rented forest earlier and had not been involved in any illegal activity. They also disagreed with the transference of all forestry responsibilities to the lessee. While the main objective in the new draft code is to increase efficiency in forestry, the methods proposed are disputed by many interest groups.³⁷ Finnish purchasers did not want to offer any opinions concerning the legislative changes. It is, however, quite clear that making private ownership possible would have an effect on their investments and business activities in Russia. Purchasing their own forest could be a wise strategic move and enable further investment in Russia's forest industry.

9 Conclusions

Contracts in the timber trade are typical "simple" contracts in a market consisting of natural resources, contracts which do not require much legal knowledge and which can be governed using relational methods. The small business circles in the sector seem to guarantee the efficiency of relational contracting, and at first sight, law does not appear to play an important role. Law, however, is present as the negotiated terms of contract offer some kind of framework for building and maintaining trust. Only in very rare cases do the contracting parties resort to the law, let alone use legal methods of solving disputes. Law can also be a restraint on trade in a similar way to complex and constantly-changing state regulations, but between business partners there is always flexibility in interpreting the terms of contract. As a matter of fact, contract documents in this particular context are very seldom interpreted. Several of the people interviewed admitted that they had not even read the contract, having only paid attention to the contractual terms that were actually negotiated, i.e. quantities, prices and delivery conditions.

Uncertainty is the most powerful actor in the Russian market. It explains a lot more about business behaviour in Russia than asset specificity. Currently, uncertainty hinders vertical integration through high transaction costs, but encourages investment in long-term relational contracts. The circumstances prevailing in Russia do not, however, prevent proactive contracting. On the contrary they make the creation and maintenance of trust even more important than is the case in developed western market economies. In an antimodern society, trade is carried out between friends, and friends are not to be disappointed. Small circles with only a few purchasers and suppliers support trust-based business, since maintaining one's reputation amounts to a prerequisite for business survival.

Contracting in the roundwood trade is actually confusing from the viewpoint of proactive law. Keeping as far away from courtrooms as possible is good policy, but on the other hand law does not really matter in the actual business relationship. Contracts are used as some kind of framework for building trust on one hand and safeguarding exit routes on the other. Not using the safeguards

³⁷ See the discussion at the Russian environmental NGO's webpage: "www.forest.ru/legislation/newcode".

provided is a sign of trust. Contracts are not used as a tool for planning relationships, and documents are usually forgotten soon after they have been drafted. Those business people who emphasize the maintenance of good relationships with their suppliers try to avoid contact with lawyers because they think that lawyers only regard contracts a safeguard should a potential dispute end up in court. No real teamwork takes place when planning and maintaining business relationships and solving problems. Lawyers allow businessmen to solve their own problems, and business people do not even want lawyers involved in their business deals. When lawyers and businessmen do work together, the purpose is almost always to meet the requirements of legal regulations. Furthermore, it appears that contracts are written at least as much for third parties as for the contracting parties themselves.

This study of the roundwood trade between Russia and Finland proves that court-centred contract law is too far removed from the logic of actual business practice. One possible development is that legal studies will continue to ignore contractual practice. By narrowing its own scope in such a way, court-centred law will find itself on the periphery of society, far away from participating in the development of business contracting. Such narrow specialization is not in the interests of either lawyers or society.

The Proactive Law Movement does not want legal science to limit itself. Lawyers who work in a proactive manner understand business realities and can use their legal skills to make a great contribution towards improved contracting and contract management, as long as they are also skilled in cooperation and interaction. The mission of proactive law is to build bridges between contract law and business contracting, as well as between people whose professional logic differs. The best way to promote proactive law and to develop research and the teaching of law in ways that will be more useful to business is by encouraging cooperation between business people and academics. Cooperation will benefit law faculties, faculty staff and students as well as businessmen and employers, not to mention legal science itself. The group of proactive lawyers invites everyone to participate in this rewarding cooperation.

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