Legal Preconditions for Contractual Relations in the Transition to a Market Economy

The Case of Bulgaria

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IDS Bulletin Vol 29 No 3 1998

1 Introduction

Since Roman times, contract has been the basic cell of economic life upon which most productive relationships have been based. The principle of freedom and sanctity of contract is part of the commercial life paradigm of Western Europe. In 1989, the Central and Eastern European countries (CEECs) embarked on the task of transforming from economies where bureaucratic relationships between political actors prevailed, into economies where contractual relationships between economic actors would prevail. The need to put in place a stable and predictable legal framework for this transformation has been underlined in numerous policy documents and academic writings. It can be argued that such a framework is of particular importance in the context of Central and Eastern Europe. First, where private business is weak, it is vital for its development to introduce standard terms and to reduce uncertainty (EBRD 1993). Second, no deeply rooted commercial customs, tradition or implicit codes of conduct existed to rely upon in the regulation of commercial life, given the severance of links with the pre-1944 business experience of the CEECs. Even where a certain link is preserved, that experience corresponds to a different stage of economic development. Third, planned economies left the legacy of a huge misallocation of resources. An effective contractual regime could assist the transfer of resources to better uses. Lastly, foreign direct investment is contingent upon a functioning regulatory system based on the rule of law.

The transition orthodoxy (Ellman 1997), however, has failed to focus on the actual dimensions of transforming the legal framework for commercial exchange. Little research has been conducted on the problems of enforcing legal provisions, on the factors that bear upon this, and on the implications for the emerging mechanisms of organising commercial life and the overall process of transformation.

This article examines the state of the legal preconditions for establishing an economic system based on freedom and enforceability of contract. The main indicators employed are the existence of a comprehensive framework of laws governing commercial transactions, while allowing for freedom of contract and reliable mechanisms for conflict

resolution. The paper analyses the transformation of the legal framework in Bulgaria in the period 1990–97. The Bulgarian case seems a particularly good example, illustrating both problems and prospects revealed in the process.

2 Methodological notes

The state of the legal regulation of commercial contract can be approached in two ways. The first constitutes a classical law approach which examines the introduction of the main institutions of contract law as well as of the wider commercial law framework. Traditionally, the law of contract is the core of commercial law which provides the framework within which the parties can freely transact. This role is fulfilled by ensuring the following: that law fixes a standard of behaviour while allowing for free definition of the terms of contract; that it protects *bona fide* market participants acting in the ordinary course of business; and that it provides for a range of remedies for a breach of contract. Thus, as the law and economics literature explains, law of contract facilitates exchange by helping reduce transaction costs and providing for efficient allocation of economic resources.

The classical legal approach assumes a fairly static and abstract view of contract and of its economic and social role. If one introduces a time or cross-country dimension to legal institutions, however, one needs a dynamic, context-based approach. Authors such as Tillotson (1995) argue that full understanding of the law of contract can only be achieved if the latter is discussed in the context of the evolving nature of its relationship with the political and economic environment, and business practice.

In CEE, it seems particularly important to discuss the formal as well as the substantive dimensions of adoption and implementation of laws. This dual approach requires an account of the political, economic and social factors that influence the development of legal institutions. It follows from, first, the logic of totalitarianism, expressed as total penetration of all spheres of life by the system of party bureaucracy. According to that logic, law was not an instrument of regulation but of ritual communication outside the ideological power structure (Havel 1985). It was through the latter that business was done. Second, the simultaneous, rapid and multi-faceted transformation in the CEECs makes it impossible to examine institutions in isolation from their context.

3 Development of the legal framework

The transformation of the legal framework governing commercial transactions in Bulgaria formally began with the adoption of the new Constitution in July 1991. The Constitution confirmed the dramatic break with the socialist planned economy and a political commitment to 'the establishment of a democratic and social state governed by the rule of law' (Preamble). In the economic sphere, it proclaimed the principles of free economic initiative, of equality of all economic actors, and the protection of investment and economic activities, as the basis upon which the new market relations would develop.

The previous state of affairs was characterised by a system where private non-business transactions were regulated by a civil code, the Law on Obligations and Contracts of 1951; whereas relations between state-owned enterprises were regulated by special legislation and acts of administration. The contractual freedom of state enterprises was limited in the sense that they were subject to the constraints of central planning and to political interference, and normally had a limited range of remedies available for a breach of contract. Thus, some of the first reform measures were connected with the elimination of this distinction by repealing the provisions concerning the special contractual regime for state-owned enterprises.

The second main task was the introduction, or restoration, of commercial law in the private law system of the country. In harmony with the continental and its own pre-1944 tradition, Bulgaria opted for a dualist system through the incorporation of commercial law as a separate branch. Commercial law was envisaged as a special civil law of traders, governing the transactions by which the exchange of goods, services and capital are carried out or facilitated. Thus, it includes company law, law of commercial contract, the more specific laws of transport, insurance and banking contracts, securities, maritime, corporate insolvency law and

international commercial law. This special regime, according to legal theory, would meet the somewhat contradictory needs of commercial life for flexibility and speed, through the provision of simplified legal form, standardisation and uniformity of legal institutions, and for certainty and stability, through ensuring greater publicity, protection of the rights of the weaker parties, more imperative provisions, and stronger sanctions (Gerdzhikov 1991).

The actual introduction of commercial law, however, did not proceed in such a neat fashion. It is important to examine the developments in some of its main areas.

- The reform started with the adoption of the Commercial Act in July 1991. That law laid down only the regime regarding the subjects of commercial law. It adopted a modern approach, incorporating European legislative provisions on governance of commercial companies. In addition to sole proprietors, commercial companies and cooperatives, the scope of the Act extends over state- and municipally-owned companies. The latter's governance, transformation and privatisation, however, were subject to a special regime incorporating many public administrative law provisions. This regime could be characterised by a constant change in policy priorities and a lack of good co-ordination between the institutions responsible, thereby resulting in an unstable and ambiguous normative environment.
- The law of contract was not substantially amended until 1993, when some changes to the Law of Obligations and Contracts were made, repealing the special regime applicable to state-owned companies. A new regulation of commercial contracts was adopted only in 1996 in the form of Part Three of the Commercial Act. These amendments developed the contractual regulation in accordance with the new market mechanisms. They include regulation of all main commercial contracts with the exception of a number of contracts already used in commercial practice, such as franchising, factoring and sponsorship, and with the exception of contracts subject to special regimes, such as privatisation and stock exchange transactions (Gerdzhikov 1997).
- Banking law was developed within the overall process of reform of the banking system. Accordingly, new laws were adopted in 1991 and 1992. The regulation of the banking system, however, did not provide for efficient banking supervision. The period could be characterised by extremely distorted credit behaviour of state as well as private banks, favouring particular economic groups and a limited number of loss-making enterprises (OECD 1997). This resulted in a severe strain on the state budget in recapitalising banks, loss of confidence in the banking system as a reliable channel for servicing transactions, and a severe financial crisis in 1996. The regulatory regime was substantially improved in the summer of 1997.
- Regulation on securities transactions was adopted in 1995 as part of the package of laws designed to facilitate privatisation through investment vouchers. It put an end to a period of spontaneous and non-regulated development of securities trade which was characterised by a number of notorious financial pyramid scandals. The institutional framework for stock exchange transactions was developed only at the end of 1997.
- Legislation on corporate insolvency, being the final remedy for non-performance of contracts, was introduced in 1994 as Part Four of the Commercial Act.

The review of the main developments shows that there was a significant delay in introducing the special regulation of the law of commercial contract. On the one hand, this may not necessarily be seen as negative because one of the main hindrances for market contracting was removed fairly early by applying the same regime to all legal subjects regardless of their ownership. Equally, no problem existed in the regulation of ordinary transactions. They were carried out by free contracting on the basis of the classic institutions of sale, deposit and loan. Any gap or lack of clarity was resolved by the application of general civil law.

On the other hand, the regulation was inadequate as far as the contractual framework for complex economic initiatives was concerned. Especially in matters involving financial instruments or currency options, commercial practice still runs ahead of the legislation by borrowing contractual models and

adapting foreign business practices. In general, it is possible to observe that, in addition to its late adoption, the regulation of the complete cycle of business exchange, and especially of its financial aspect, lacked system, continuity and depth. A piecemeal approach with no comprehensive strategy was followed. Ultimately, the unpredictability of rule-making posed a burden for planning of economic resources and increased transaction costs. It also largely inhibited the interpretation, dispute resolution and enforceability of contractual obligations.

The process was also influenced by the persistent strong involvement of the state in economic life, especially in the area of the transformation of state-owned enterprises. This, in conjunction with the delay of privatisation and the lack of continuity in government priorities, resulted in prolonged politicisation of business decision-making.

The main reasons for the failure of the state to create a credible legal environment seem to lie in the political sphere. The legacy of Bulgarian communism left society extremely atomised and fragmented. Although there were opposition initiatives before 1989, political reform in Bulgaria was initiated by reform-oriented communists. They were the only well organised group possessing executive skills and business experience. They managed to retain significant control over policymaking, but also to use their privileged position to gain quick economic benefits in a period when the old system was being deconstructed. Powerful groups were formed that had vested interests in the state of uncertainty, and they, together with the beneficiaries of the previous regime, effectively prevented significant advances in the transformation. It was only gradually that an organised democratic opposition, able to formulate an alternative viable project for reform, developed. The opposition sought to strengthen its economic and social base through policies of restitution of property to its former owners or their descendants, thus neglecting other tasks of the transition.

Therefore, the political process resulted in extreme political instability: there have been eight governments, including three non-party expert ones, since 1990, which failed to carry out policies on the basis of agreed priorities for reform. Rather, the state acted in response to pressure: internal pressure generated by the flourishing mafia groups in the economy, or external pressure, such as the conditions imposed by international financial institutions (Minchev 1997). Legislative change has often been simply a part of the electoral platform of some political forces. Often, it did not fix best practices, or aim at putting in place the regulatory function of law. It aimed at declaring that something is being done, winning support either at home or abroad, without actually putting in place a viable framework for a particular policy implementation.

4 Conflict resolution and enforcement

Normally, the substance of contracts is largely determined by the will of the parties participating within the framework defined by law. There are some self-enforcement mechanisms that work to this end, such as discussions between the parties or their reputation in the market place. The alternative, however, is a breach of contract and a commercial dispute. Traditionally, there are three types of conflict resolution mechanisms: court litigation, voluntary arbitration, and alternative dispute resolution, such as mediation and conciliation. Conflict resolution and enforcement seek to compensate for the default of one of the parties in providing a market value. In the absence of such mechanisms, no certainty over the contractual relations could be ensured and this would ultimately result in inefficient allocation of resources.

Conflict resolution and enforcement by the courts

Effective and reliable judicial enforcement is one of the legal fundamentals of any contractual regime. It has been the consistent opinion of businesses, lawyers and policymakers that the Bulgarian court system is inefficient, clumsy and costly to the extent that it has been meaningless to rely on it for conflict resolution in a dynamic market environment. The court statistics for the years 1993–95 published by the ministry of justice confirm the slowness of the system. Despite a slight increase in the number of new claims filed to the courts, especially of claims resulting from contractual disputes, there is a decline in the number of civil law cases on trial, as revealed in Table 1. Table 2 demonstrates an extremely high percentage of hearings adjourned, and a steady increase in the number of cases

Table 1: New civil claims and cases on trial

	1993	1994	1995	1996
District courts I instance				
New civil claims	22,418	22,796	23,426	n.a.
of these: – new contractual claims	6,879	7,971	8,216	n.a.
– cases between traders	5,718	5,918	5,871	6,212
Total cases on trial	142,805	113,031	107,789	n.a.
Company law cases on trial	120, 805	90,235	84,363	67,124
District courts II instance (total)	19,520	20,795	21,587	n.a.

Source: **Ministry of Justice Bulletin**

Table 2: Court efficiency: cases adjourned and cases completed as a percentage of total cases on trial

	1993	1994	1995
Local courts			
Hearings adjourned (per cent)	58.65	54.01	60.96
District courts I instance			
Hearings adjourned (per cent)	67.51	64.61	65.34
Unfinished cases (per cent)	11.95	17.00	20.58
District courts II instance			
Hearings adjourned (per cent)	25.04	28.33	31.84
Unfinished cases (per cent)	24.34	24.08	31.84

Source: **Ministry of Justice Bulletin**

Table 3: Efficiency of enforcement procedure: number of claims filed and of cases completed

	1989	1990	1991	1992	1993	1994	1995
Claims	120,060	96,056	93,626	138,048	102,259	90,882	112,957
Completed cases	114,240	98,597	93,052	107,665	95,337	81,340	94,115

Source: **Ministry of Justice Bulletin**

unfinished towards the end of each year. The analysis of the progress in the enforcement of judicial decisions (Table 3) reveals a drastic increase in the percentage of unfinished cases relative to new claims made. As a number of annual reports of the ministry of justice show, this ratio is particularly high for enforcement cases in favour of commercial companies and banks. Such delays are particularly damaging to the quality of compensation, given the prolonged periods of high inflation in the country.

A number of reasons can be advanced for the state of affairs described above. For example, the difficulties in enforcement of remedies could be attributed to the multitude of unsecured contracts and to the behaviour of banks in fulfilling court orders. The emphasis here will be on legal factors, such as the need for reform of the Judiciary and of the civil litigation procedure.

One of the first measures in the reform of the Judiciary system was to ensure its depoliticisation and independence. The new Constitution of 1991 proclaimed the principle of separation of powers and independence of the court system from the rest of government. It provided for independent governance of the Judiciary by a High Court Council and prohibited party membership of judges. The council had to be elected by parliament and the members of the Judiciary itself. The Law on the High Court Council was passed during the same summer.

Another area of reform of the Judiciary was the abolition of the system of state arbitration, introduced in 1950 as one of the mechanisms of central planning. It consisted of a High Arbitration Court and district arbitration courts as well as intra-industry courts of arbitration. These courts were the only institutions to resolve conflicts between state enterprises. Disputes with an international dimension were adjudicated by a special Arbitration Commission for Foreign Commerce. In 1988, an Arbitration Court was established with the Bulgarian Chamber of Commerce and Industry, which replaced the commission. The system of state arbitration was repealed in 1992, and the arbitration courts dissolved. It was decided to establish a unitary system of justice, where the general courts would decide on civil as well as commercial cases between economic actors acting within the general litigation procedure, thus assuming the functions of the state arbitration courts as well.

The deconstruction of the old system of justice was carried out by 1992. The transformation of the courts system to meet the demands of a market economy, however, was crucially delayed. The Constitution of 1991 provided for a reform of the court system from a two-tier to a three-tier one. Nevertheless, no practical measures for the reorganisation of the court system were taken at that stage. The structural reform did not proceed any further until 1994, when the Judiciary Act was adopted. The act laid down the details for the organisation of the system. Its entry into force was delayed by many of its provisions being challenged at the Constitutional Court. Finally, elections for the supreme courts and the other main structural changes were initiated in 1997. It is certain that the lack of reform did not relieve the workload of the existing Supreme Court: its need to act both as an appeal court and a court of final instance was a major reason for the delays.

It has to be pointed out that throughout the period under examination, no major changes to the rules of the Civil Litigation Code of 1952 were made. The order of proceedings, the substantive requirements and procedure for appeals, the system of summons, the enforcement mechanisms, and the system of interlocutory injunctions were inadequate to the requirements of a conflict resolution process characterised by speed, efficiency and reliability. It was only with the amendments of 1997 that several important changes were introduced. First, the adversarial system of litigation was promoted, thus reducing the workload of judges and avoiding delays in clearing cases. Then, the system of summons, which was a major reason for postponing hearings, was improved. Special attention was paid to the litigation discipline of the parties through increased sanctions for abuse of procedural rights. Not exercising procedural rights in good faith seemed to be one of the main problems of post-1990 disputes. Some of the mechanisms for enforcing remedies for a breach of contract were changed with the aim of improving the speed and effectiveness of delivering compensation. The changes, however, are still subject to serious criticisms for giving endless appeal opportunities, for not providing for proper co-ordination with administrative law appeals, and for not improving sufficiently the enforcement mechanisms system.

Another major impediment to effective conflict resolution by the Judiciary was related to human resources. A general lack of sufficient numbers of judges has been reported every year by the ministry of justice. Although some measures were taken, in total about 10 per cent of the judicial positions in the local courts, and between 16 and 20 per cent of the positions in the district courts, remained unoccupied throughout the period. In 1995 there was no court working with a full number of judges. The problem of understaffing was particularly acute in the bailiff departments, dealing with the practical enforcement of judicial decisions, in more remote areas of the country. Judges leave because of low pay and the higher profits in the private sphere. Many judges had never before dealt with commercial cases and the growing pressure in a changing economic and legal environment proved decisive. The positions have been filled with new graduates with no experience at all in running court proceedings and resolving complex commercial matters. In 1993, for example, 65 per cent of the judges in the local courts had less than one year's job experience. As a result, judges with insufficient professional experience were promoted to the district courts. The professional qualification of judges clearly becomes a problem which affects the quality of judicial acts and the speed with which they are announced. For bailiffs, in particular, given the lack of court police, the issue of personal security has become an important disincentive for efficient performance.

The activities of the Judiciary are also influenced by questions of proper administration. The lack of properly qualified administrative staff has been reported as a major impediment to the efficient operation of courts. Material resources for creating normal working conditions in terms of equipment, databases, libraries etc. are badly lacking. Thus, the cost of the transformation of the Judiciary proved to be beyond the means of the state budget.

The troubled reform of the Judiciary demonstrates, on the one hand, that it was not among the priorities of the transition process. No political consensus really existed on the importance of a well functioning Judiciary as a guarantee for the rule of law. The problems of corruption and the links between the state and organised crime were recognised and addressed only in 1997. The 'lawlessness syndrome' (World Bank 1997) was a good way of accumulating capital or preserving a position. On the other hand, a legal reform of this scale requires substantial legal qualification and a sense of history on the part of its authors. Despite the fast learning process that a whole generation of lawyers and businessmen is going through, time is necessary for specialised experience to accumulate.

Other conflict resolution mechanisms

As discussed above, the system of state arbitration was abolished in 1992. The only arbitration court that remained was the one attached to the Bulgarian Commercial and Industrial Chamber. The Arbitration Court substantially reformed its statute and rules of procedure to meet the new market conditions. Thus, a possibility existed for combining the advantage of dispute resolution by arbitrators experienced in dealing with economic transactions, especially those with a foreign trade dimension, and of a cheaper procedure characterised by greater speed, simplicity and confidentiality.

The annual reports of the Arbitration Court reveal a steady decline of requests for international arbitration, from 183 in 1992 to 48 in 1996. The requests for domestic arbitration have been more stable over time: approximately 100 cases per year. Unlike the situation in the courts system, between only 10 and 13 per cent of the cases have been postponed, mostly for reasons of difficulties in summons. On average, more than 60 per cent of domestic claims have been resolved within six months of being filed, which reveals the potential of arbitration as a dispute-solving mechanism. The small number of applications filed with the Arbitration Court, according to some arbiters, could be explained by lack of confidence in the court, given the legacy of partiality and corruption of many of its members. In addition, the decisions do not deliver sufficient protection for the rights of the parties in terms of enforcement of remedies.

Nevertheless, the potential of arbitration as a dispute-solving mechanism has been proved by the growing number of new arbitration courts set up by voluntary civil or professional organisations: the Association of Economic Initiative of Citizens, the Association of Commercial Banks, and the National Union of Corporate Lawyers. There are also discussions on the need to employ this mechanism in insurance and labour disputes.

5 Conclusions

The review of developments in Bulgaria shows that adequate legal preconditions for an economic system based on the rule of law and enforceability of contractual obligations were not put in place. Piecemeal methods of rule-making were employed, which put a strain on implementation and created an unpredictable regulatory environment. Bureaucratic and politically motivated action persisted, interfering with the principle of freedom of contract. The slow reform of the Judiciary deprived market participants of an effective protection of their lawful interests. However, after the financial and political crisis of 1996, dramatic improvements in the legal framework were made during 1997 (see section 4 above).

The difficulties of substantive transformation of legal institutions are tightly connected with the characteristics of the political process in Bulgaria and with the lack of clear reform priorities. The state failed to establish itself as an impartial, legitimate regulator of economic life. As a result, the totalitarian economy was largely transformed into a criminal rather than a market economy. There are also important objective reasons, such as the cost of legal reform and the intense learning this requires on the part of the whole society.

It is difficult to establish a strict causation link between the problems of the development of the legal contractual framework and the dynamics of the economic transition. The general question of how much legal regulation markets need in order to operate, could be raised in the context of Central and Eastern Europe too. Businesses respond to regulatory failures by developing various forms of inter-firm integration and relying on old social networks. In this article, however, it was argued that legal fundamentals related to the sense of equity and stability of business life are especially important in the post-totalitarian context. The example of Bulgaria illustrates this at great social cost.

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