

EXTERNAL ENVIRONMENT, TRUST AND EAST-WEST TRADE

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A model of trust and commitment in international inter-firm alliances in conditions of legal uncertainty/hostility is presented with propositions for testing. Conditions in four Central and East European countries are profiled with respect to varying legal environments and the potential effects of those environments on foreign investment and cooperation.

Keywords: trust, contracts, international channels, channel relationships

Introduction

Research on trust, law, and inter-firm cooperation is one of the growing areas in international business. In part, this results from the many complexities involved in the rapid growth

of international business and the expansion of many firms across regional blocks to firms and countries with very different attitudes toward markets, contracts, and business ethics. As a consequence, intellectual property conflicts, lax or biased contract enforcement, and diffe-

ring valuation of assets have become serious barriers to business investment/expansion and the cause of costly fraud prevention systems. This problem affects both countries and firms, leading to inefficiencies, lower investment, and increased costs. Widespread recognition of the problem first surfaced as Western companies began increased manufacturing and marketing in Asia during the 1980s and 1990s. Although a number of initiatives have moderated conflicts there, the opening of former Soviet areas to investment and sales focused attention once again on the incompatibility of systems with differing codes of commercial conduct. Academically and practically, therefore, there is much interest in the topic of trust among businesses in the value chain.

This paper offers a research model for investigating the elements of trust, relationship commitment, and the impact of the legal environment in which business partnerships are arranged on inter-firm investment and performance. It is hypothesized that uncertain and hostile legal environments generally have a negative impact on relationship investment and the quality of overall investment, although strong inter-firm trust may lead to greater commitment as long as reliable partners are scarce. To illustrate the research agenda, selected country examples of differing legal environments are presented in some detail.

Modeling inter-firm relationships

Investigations of inter-firm relationships have increasingly focused on the roles of trust, commitment and outcomes (typically performance) in examining how these relationships are formed and conducted. Trust, in particular, has become a focus since it seems to affect the depth and duration of relationships as well as the specific form of the alliance (Brothers,

Brothers and Werner 2001; Luo 2002b). While in a non-academic sense, trust is seen as an integral part of relationship formation and conduct; unsurprisingly, modeling and testing trust is not so simple. Depending on the disciplinary perspective the role of trust is unsettled. In economic and strategic studies, trust is most typically modeled as an independent variable affecting performance through the impact on co-operation, transactions costs, and capability (Gulati 1995; Inkpen 1997; McAllister 1995; Tsai and Ghoshal 1998). Psychologically derived research typically models trust as a moderating variable encompassing perceptions of integrity, vulnerability and reliability (Coote, Forrest and Tam 2003; Rousseau, Sitkin and Camerer 1998). It is seen as both antecedent to, and a part of, inter-organizational business commitment. Sociologically oriented scholarship models trust as a dependent variable resulting from the context and relationship history (Anderson and Narus 1990; Doney and Cannon 1997; Morgan and Hunt 1994; Zhang, Cavusgil and Roath 2003).

The second issue with respect to trust lies in the impact of other factors on both the amount and the consequences of trust. Both Luo (2002b) and Zhang, Cavusgil and Roath (2003) agree from their extensive literature reviews, however, that the importance of trust, with respect to alliance outcomes, seems to rise when there is greater environmental uncertainty, disparities in decision-making routines, or disparities in the background of the actors involved (see also de Ruyter, Moorman and Lemmink 2001; Gundlach, Achrol and Mentzer 1995; Morgan and Hunt 1994). More recent research has begun to focus precisely on environmental factors such as cultural distance, ownership type, market uncertainty, cultural context, and commercial environment (Dmaskopoulos and Evgenious 2003; Eriksson and Sharma 2003; Zabkar and Brencic 2004).

The third issue lies in the theoretical and operational definition of trust. While there is general consensus the devil lies in the details. Some definitions stress the attitudinal aspect, e.g., a belief in the reliability and integrity of the partner (Morgan and Hunt 1994). Others add a behavioral component, which includes indicators that support the belief such as confidential information sharing or cooperation in relationship formation (Anderson and Narus 1990; Zhang, Cavusgil and Roath 2003). In either case, trust is seen as developing during the course of the relationship. However, as Luo (2002a) observes, trust is also required to form the relationship. This is the root of the uncertainty in determining the causal direction of trust and commitment. Boersma, Buckley and Ghauri (2002) have offered a process model of trust with three types of trust: *competence-based* (belief in ability and willingness to perform), *promissory-based* (explicit agreements) and *goodwill-based* (character or personal behavioral expectations). Building on earlier works by Sako (1992) and Ganesan (1994), this approach posits that the aspect of trust examined may affect the role and consequence of trust in models. They hypothesize that the influence and importance of these dimensions differ depending on the stage of a business relationship.

The key notion is that trust is the offset to the inherent risk involved in constructing and conducting an inter-firm relationship. Thus, risk is present both at alliance formation and during its operation, but the object and extent would vary. In the Boersma, Buckley and Ghauri (2002) study, they conclude that promissory trust is more important early in the relationship and that competence trust develops as the partner's behavior is visible and assessable over time, while goodwill-based trust is important at all stages. The risk in initiating

the relationship involves both competency and integrity, so negotiations play a dual role: they establish the actual contract of the relationship, but they also work to establish a sense of the degree to which the prospective partner is reliable and honest.

The introduction of exogenous environmental variables such as cultural norms and legal environments raises the question of whether trust needs to be extended or modified to account for these additional factors. That is, whether the parties in the relationship need to also establish some agreement with respect to controlling norms and the recourse (or not) to legal enforcement. Thus, to some degree, the partners must include an assessment of their trust in the environment and incorporate that into their initial negotiations and subsequent activities. In an uncertain or hostile legal environment, that may well limit the extent of behavioral commitment – amount of direct investment, sharing of resources, joint research and development, etc.

Trust importance and influence may also vary by the mode of market entry (Buckley and Casson 2003). Both the level and types of risk differ by mode: joint ventures, for example, require a higher level of asset investment and a deeper level of entanglement with a multitude of laws in the host country than, for example, exporting. Thus, the macro-level (environment) and micro-level of trust should differ in effects and interaction by mode. Alternatively, the need for greater control due to environmental uncertainty may lead to greater reliance on either full control or highly limited relationships. This dualism has cost and development implications.

In short, trust has both attitudinal and behavioral dimensions. It is not a unitary construct. It requires an iterative model to account for evolution over time and can be affected by

factors outside the relationship (Luo 2002a; Rousseau et al., 1998).

Legal environment

In countries with transparent and stable laws and legal systems with trustworthy dispute resolution systems, business law can augment or replace some aspects of trust. This has been discussed in the literature concerning the relationship between trust and contract law. If a contract is legally enforceable, the parties need relatively less trust in each other to perform their promises (Bellia, 2002; Kimmel, 2000). In addition to augmenting or replacing trust, clear enforceable contracts reduce transaction costs, align expectations during contract performance, and make the outcomes of disputes more predictable (Hendley, Murrell and Ritterman, 2001). However, in legal systems where the judiciary may not enforce the promises or where law enforcement does not carry out legislative and judicial orders on a reliable basis, interpersonal forms of trust become far more significant. Other environmental factors such as the degree to which the law is predictable, whether the rules are clear and whether there is a significant degree of corruption also affect the importance and role of relational trust and contract (Smarzynska, 2002).

Rather than focus on issues of general contract law, this paper focuses primarily on the laws governing intellectual property rights (IPRs). IPR laws protect copyright, patent, trademark and trade secrets. We focus on IPR law because it is more likely to reflect the shared resource and trust issues than laws governing other methods of market entry in international business, such as trade or direct investment. Furthermore, international and national protection of IPRs is a critical issue for businesses and nations. National intellectual

property protection has become "married" to international trade issues (Sherwood, 1997). The importance of IPRs as a trade issue is apparent from the 1994 World Trade Organization (WTO) Agreements which, at the insistence of IPRs exporting nations, included the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPs). TRIPs requires all current and future members of the WTO to enact and enforce strong intellectual property laws in line with international standards or risk trade sanctions (Maskus, 1998). Because of this, instituting IPRs regimes and enforcing those laws is of great importance in transitional economies of Central and Eastern Europe as they enter or seek admission to the WTO. Whether these and other nations enact and enforce IPR laws is an issue of great importance to businesses in IPR exporting countries in Western Europe and the United States. Often, intellectual property is the most valuable asset of these companies and whether a particular nation will protect that asset will determine not only whether a company will do business in that country, but also the form that business might take.

An additional reason for focusing on IPRs is that studies generally support an expectation that stronger IPR protection enhances all forms of market entry, including importing, technology licensing, and foreign direct investment (Lesser, 2001; Sherwood, 1997; Smarzynska, 2002). Strong IPRs protect exporting firms from local copying of the product, allowing the exporting firm to sell more (Maskus, 1998.) Empirical evidence indicates that if all other factors are equal, countries with stronger IPRs attract more imports (Maskus, 1998). The strength of IPRs laws also impacts the licensing of those rights. Licensing is insecure in countries with weak intellectual property laws, and companies with easily replicated

technology or other property are less likely to license in those countries (Maskus, 1998). The strength of IPRs protection also impacts foreign direct investment (FDI), although how IPRs influence foreign direct investment is both a subtle and complex issue. Strong protection for IPRs alone does not generate enough incentive for FDI. However, IPR protection is an important component of a nation's overall regulatory scheme (Maskus, 1998) and there is support for a level of relationship between IPR laws, enforcement regimes, and other forms of direct investment.

In an empirical study conducted for the World Bank, Smarzynska (2002) concluded that weak protection of IPR significantly impacts the composition of FDI inflow into a country. The study indicates that investors respond to both the "laws on the books" and to their enforcement (Smarzynska, 2002). For inventors in technology sensitive industries, such as drugs, cosmetics, chemicals, machinery and electrical equipment, IPR plays a prominent role; weak protection encourages investors to set up distribution facilities rather than engaging in local production (Smarzynska, 2002). Firms with easily copied products and technologies are more concerned with the strength of IPRs. These sectors include pharmaceuticals, chemicals, food additives, and software (Maskus, 1998). In addition, the importance of IPR protection depends on the kind of investment a company plans. A survey conducted by Mansfield (1994) indicates that IPR protection is important to 20% of manufacturing firms investing in sales and distribution outlets. The percentage increased to 50–60% for investments in manufacturing components and complete project and to 80% when research & development facilities were involved (Mansfield, 1994).

Given the importance of IPR issues in in-

ternational trade regimes and to IPR sensitive businesses seeking to expand globally, the strength of a nation's IPR laws and legal regimes enforcing those laws may serve as a proxy for other forms of laws when analyzing the relationship between trust and laws governing business transactions.

Concerns with these legal and trust issues reflect a transaction cost perspective: that is, parties ought to seek exchanges, which minimize costs and maximize profit opportunity. Since conflicts create costs, continuous short-term alliances appear to be more costly than long-term ones. Thus, both enforceable law and trust are behavior systems designed to reduce cost and increase profitability. On the other hand, temptations to opportunism of various kinds may be greater in uncertain environments, so short-term personal gain also becomes long-term social cost (Buckley and Casson 2003). Additionally, as Eriksson and Sharma (2003) point out, since firm competitive advantage depends, from a resource-based perspective, on the quality of external as well as internal, exchange relationships for resources, uncertainty undermines cooperation and, therefore, resource creation (Anderson and Weitz 1992; Blankenburg, Eriksson and Johanson 1999).

Commitment

Like trust, commitment has both attitudinal and behavioral elements. The attitudinal portions represent an element of both the goodwill trust and an intention to continue, which is possibly related to promissory trust. The key element, however, is the behavior. Initially, it can be the creation of a contract, the contents of the contract, or the establishment of investments of intellectual or real property (Mayer, Davis and Schoorman 1995; Ring and Ven

1994) These “credible commitments” (Williamson 1983) provide the foundation for risk sharing and shared outcomes that affect performance and future trust.

Typically, contracts are often the first visible behavioral commitment. However, in conditions of legal uncertainty or hostility, contracts may be equivocal (Yan and Gray 1994). For the reasons discussed above (section on Legal Environment), given a system of explicit laws and reasonable expectations of enforcement, contracts may be less detailed and specific, particularly with regard to property rights. This, in turn, allows partners to act in the best interest of the alliance without extensive negotiation and consultation as situations arise. However, in uncertain or hostile legal environments, the lack of those systems’ guarantees requires that either the contract spell out ownership and decision elements in great (and confining) detail or lesser investments will be shared.

The movement from uncertainty to hostility along the legal environment continuum should be reflected in both the contracts and the real investments of the parties. Indeed, Luo (2002b) and Zhang, Cavusgil and Roath (2003) report their research to show that laws and (in)effective enforcement affect partnership relationships in terms of investment type, quantity of investment and performance outcomes. Alternatively, Zabkar and Brencic (2004) found that Serbian relationships were more likely to base on interpersonal trust and involve more shared responsibility, but in Croatia arrangements were more formal and more likely to rely on systemic qualities, such as legal protections, despite the hostile legal environment and pervasive cooperation.

The limited research in the area of legal environment effects on business relationships and international investments suggests that

there is an impact, but the dimensions of that impact and the connections with types of relationships, types of investment, and areas of shared responsibility are still largely unexplored. The research proposed with the model presented next is a first step to widening the exploration of these issues.

Model

The model is based on the contingency factor, meaning that variations in trust, commitment and mode of entry vary depending on the structure of legal environment. The model also is recursive in nature, providing a feedback loop. Over time, trust and commitment levels in strategic alliances or partnerships vary. For example, if a business performance in a partnership reaches certain levels, trust in such relationship can increase. Finally, based on transaction cost analysis (TCA) approach, parties can minimize transaction cost by engaging in a long-term relationship and, subsequently, increasing resource growth from such alliance (Andersen 1997).

The model operates in the following manner. When two business partners enter into alliance, a certain level of trust is developed between the parties. Trust, then, directly affects the level of commitment as it occurs in the alliance. Depending on how committed the businesses are to each other will subsequently affect both performance of that alliance as well as the mode of entry into the marketplace.

The legal environment will modify all three components in a progressive manner. In highly uncertain and turbulent legal environments, goodwill will be perceived as the most important source of trust. Commitment to an alliance should also decrease as the turbulence in a legal environment increases. The link between commitment and performance can be ex-

plained in non-financial terms, such as market share, reputation and market access (Brouters 2002). If the investing partner is less committed to the alliance, the non-financial performance is likely to decrease.

The performance of an alliance and mode of entry are inter-related concepts (Buckley and Casson 2003). In an international context, business performance can be measured in financial terms, such as total sales, growth of sales and competitive performance (Akyol and Akehurst 2003). Brouters (2002) found that in European countries, firm performance is related to the mode of entry. If the performance of an alliance increases, more involved entry modes are likely to be chosen and, in the same vein, due to a success, promissory trust can be developed. Similarly, uncertain legal environments will signal that less risky and less involved modes should be chosen. Performance will act as a corrective feedback loop, either increasing or decreasing the trust in the alliance. When increased performance benefits the partnership and the return on investment grows, the formation and source of trust will be promissory in nature.

Based on the relationships between the variables in the model, the following set of propositions is suggested:

Proposition 1: When building trust, an increase in the uncertainty in the legal environment will (a) increase the perceived importance of goodwill trust and (b) decrease the perceived importance of promissory trust.

Proposition 2: When forming a business alliance, an increase in the uncertainty in the legal environment will decrease the importance of (a) temporal, (b) instrumental and (c) normative-behavioral commitment.

Proposition 3: An increase in the uncertainty in the legal environment will inhibit high-involvement modes of entry (direct investment).

Proposition 4: An increase in the uncertainty in the legal environment will weaken the commitment to the business alliance.

Proposition 5: Commitment to a business alliance will directly affect non-financial performance of that alliance.

Proposition 6: Performance of a business alliance will act as (a) a corrective feedback loop to trust and (b) reciprocal influencer of the mode of entry.

Proposition 7: Performance of a business alliance will have a positive effect on trust between the partners.

These propositions may be explored by conducting research in environments of differing legal uncertainty. Initially, extended case stu-

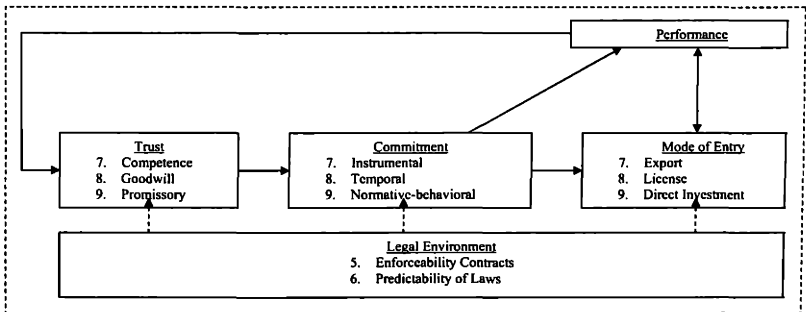


Figure: Proposed trust-based model

dies are needed in order to refine the research model and assist in the development of an empirical study. Four countries with contrasting environments, Hungary, Poland, Russia and Ukraine, have been selected for illustrative purposes in this article. These four examples provide a picture of the context envisioned in this model.

Case studies

Varying legal environments with respect to intellectual property may materially affect the form and quality of inter-business arrangements. Therefore, this paper proposes that research focus on the state of IPR legal regimes in certain Central and Eastern European both in terms of whether the laws “on the books” meet the minimum levels of protection and whether the countries have the enforcement regimes required under international law.

The IPR regimes in the Central European countries of Hungary and Poland are stronger than those of the Eastern European countries of Russia and Ukraine, but one may view a continuum of Hungary, Poland, Ukraine and Russia in terms of legal protection and enforcement. These four countries present an opportunity to examine a continuum of legal environments, from uncertain to hostile, and the effects on cross-border inter-firm business activities and investments.

Hungary and Poland

Hungary is a member of the WTO and the European Union. As such, its IPR laws must be brought into compliance with the TRIPs agreement and EU Directives on IPR. For the most part, the United States considers Hungary’s IPR laws adequate, although insufficient enforcement resources, court delays in IPR ca-

ses and relatively light penalties hamper enforcement (2004 NTR). The judicial system in particular hinders protection of patent rights because of the lack of relevant technical expertise results in cases taking three or more years to conclude and penalties are considered by the US to be too low to act as deterrents (2004 NTR).

Hungary has made great strides to modernize its legal copyright regime, which has included revisions to copyright legislation, strengthening criminal penalties, and is in the final process of harmonizing its laws with EU requirements (IIPA–Hungary). The “law on the books” is strong. However, enforcement is weak in terms of authorities preventing patent infringement, and police, prosecutor and judicial enforcement against IPR infringement is needed (USTR 2004 Watch List). Intellectual piracy is a problem in a number of business sectors. Hungary has been and continues to be a haven for sales of pirated content; in particular, music CDs produced and imported from Ukraine and entertainment software manufactured in, and imported from, Russia are problematic (IIPA–Hungary). Pirated film DVDs imported from Russia and Ukraine are also on the rise (IIPA–Hungary). Copyright problems continue to persist in business software sectors and print media, including pirated journals and books, particularly academic textbooks (IIPA–Hungary). Copyright industries report that piracy of audiovisual works and copyrighted software are at unacceptably high rates (2004 NTR).

Poland is a member of the WTO and the European Union. As such, its IPR laws must be brought into compliance with the TRIPs agreement and EU Directives on IPR. In recent years, Poland has significantly improved the “laws on the books,” but problems remain concerning enforcement of copyrights, trade-

marks, and patents (2004 NTR). Copyright industries report that piracy in Poland is high and that 2002 levels are: 43% for sound recordings, 30% for motion pictures; 54% for business software, and 91% for entertainment software, e.g., games (2004 NTB; IIPA–Poland). Poland differs from Hungary in that companies in Poland produce infringing CDs, DVDs, and CD-ROMs, whereas the issue in Hungary primarily concerns pirated imports (IIPA–Poland). Imports are also a problem in Poland with substantial pirated music coming into Poland from Eastern European countries. Russian-made pirated DVDs are the top piracy problem for the motion picture industry in Poland, and Russian-manufactured PC-based entertainment software is the predominant form of entertainment software piracy (IIPA–Poland). Business software piracy and unauthorized photocopying of academic texts and journals remain high (IIPA–Poland). Copyright enforcement has improved in recent years but the judicial system, particularly given a general lack of knowledge about IPR by prosecutors and judges, continues to be an impediment (NTR 2004). Judges and prosecutors are undergoing training in IPR laws, and Polish courts have recently begun hearing criminal copyright infringement cases (IIPA–Poland). The common problem copyright industries experience is failure of the courts to issue sentences and fines in criminal infringement cases to deter infringement (IIPA–Poland). Civil cases for copyright enforcement in Poland are not yet viable because of procedural delays which can take up to five years for an infringement case to be heard (IIPA–Poland).

Russia and Ukraine

The state of IPR laws and enforcement in Russia and Ukraine is much worse than in Hunga-

ry and Poland, as can be seen simply from the export of illegal materials into Hungary and Poland. In Russia, there is a critical need for both legal reforms and better enforcement (IIPA–Russia). As part of its membership in the WTO, Russia has passed laws to meet its obligations under the TRIPs agreement. This includes amendments to trademark, patent, and computer software and database protection law (NTE 2004). However, aspects of Russian IPR regime, including its copyright law and general IPR enforcement, don't meet the standards of TRIPs (USTR Priority Watch List). Despite changes in the laws, according to industry sources, piracy of copyrighted films, videos, sound recordings, books and computer software exceeded \$1 billion in 2003 (NTE 2004) and levels of piracy of 75% in the motion picture industry, 64% in records & music, and 80% in the entertainment software industry have been reported (IIPA–Russia). Factories in Russia manufacture, distribute, and sell pirated CDs, videogames, VCDs and DVDs (IIPA–Russia). Organized crime is involved in many aspects of copyright piracy in Russia, and profits rival or exceed those made through distribution of illegal drugs (IIAC–Russia). As an illustration, the level of piracy for entertainment software is 80% of the market, with the Russian syndicates controlling all of the production in Russia of PlayStation® video and personal computer games (IIAC–Russia). It is believed that four syndicates control illegal distribution networks in Russia, and with weak border control, exports to central European countries are high (IIAC–Russia; USTR Priority Watch List). Pirated text and reference books and unlicensed translations of fiction best-sellers are available for download from websites, and the Russian syndicate increasingly controls the pirate book business (IIAC–Russia).

In addition to having less than adequate laws on the books, as the levels of piracy and involvement of criminal groups indicate, overall enforcement in Russia is inadequate (NTE 2004). The criminal enforcement system has been called the "weakest link" in the Russian copyright regime and identified as the cause of high piracy (IIAC–Russia). The number of police and judges with expertise in IPR issues is small and officials don't consider IPR infringements as serious as other offenses (NTE 2004). US investors consider the Russian court system ill-prepared to handle sophisticated patent cases, although a specialized patent chamber has been created to handle trademark and patent disputes (NTE 2004). A number of copyright cases have been filed in the *arbitrazh* courts, specialized courts for commercial disputes. There are few sources of data concerning how foreign litigants do in *arbitrazh* courts (Hendrix 2001), however, the US business software industry won several cases against a defendant who installed illegal copies of business software into computer systems and against corporate end-users that used illegal software (IIAC–Russia). Despite these wins, the state of copyright law in Russia still makes it difficult to apply civil remedies (IIAC–Russia).

Ukraine is not yet a member of the WTO, but as part of its ongoing efforts to negotiate accession, it has adopted legislation to bring

its IPR laws in compliance with TRIPs (NTE–Ukraine). However, both legal protection and enforcement remain weak and Ukraine is one of the world's largest producers and distributors of illegal CDs, audiovisual VCDs, and CD-ROMs containing entertainment and business software (IIPA–Ukraine). In order to combat piracy, the Ukrainian government has set up units to deal with IPR violations, but they are unable to deal with the "enormous number of IPR infringements" (NTE–Ukraine). The judicial system is not reliable, because the number of judges trained in IPR law is low and enterprises lack confidence in the judicial system (NTE–Ukraine). In addition, endemic government corruption and unreformed bureaucracy lead to both necessary and unnecessary illegal activity by otherwise reputable businesses.

These four countries present an opportunity to examine a continuum of legal environments, from uncertain to hostile, and examine the effects on cross-border inter-firm business activities and investments. In particular, we hope to advance our current understanding of these business arrangements by examining the modes of alliances, the implications of the legal environment on the quality and type of investments, and the impact of experience in the alliance on modifying the initial arrangements.

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IŠORINĖ APLINKA, PASITIKĖJIMAS IR PREKYBA TARP RYTŲ IR VAKARŲ

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Santrauka

Darbe pristatomas pasitikėjimo ir įsipareigojimų modelis tarptautinių aljansų įmonių, veikiančių nepribėrtoje ir priešiškoje teisinėje aplinkoje. Kon-

krečiai analizuojamas keturių Vidurio ir Rytų Europos valstybių skirtingos aplinkos bei jų poveikis užsienio investicijoms ir plėtoti bendradarbiavimą.

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