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# Conform or challenge? Adjustment strategies of sanction-torn companies

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business strategies under sanctions, sanctions avoidance, sanctions effectiveness

## 1 | INTRODUCTION

Russian President Vladimir Putin was smiling when he stood between Daimler CEO Dieter Zetsche and the German Federal Minister for Economic Affairs, Peter Altmaier, at the opening event of the first plant for Mercedes-Benz Cars in Russia on 3 April 2019. Two years before, in the midst of the sanctions dispute between the European Union (EU) and Russia, the German car manufacturer had released the plans for building a production plant in the Moscow region worth more than EUR250 (US\$285) million and offering jobs for more than 1,000 workers. The investment seems beneficial for both Daimler and the Russian state. For Daimler, the Russian market is an attractive sales market with low production costs (Daimler AG, 2017), while for local authorities such investments prove that companies still have trust in the Russian market (Esch & Mauder, 2019).

Daimler is just one of many companies that increased their engagement in Russia in the past few years and this makes us wonder whether this move is a common strategy of companies, which carry the economic burden of a political dispute. Although largely neglected in the political economy literature, firms' reactions to sanctions and the reasons for their strategic choices are crucial to identify and examine because the behaviour of companies determines the effectiveness of sanctions. There are two aims of this paper: first, we analyse which adjustment strategies companies undertake while operating in a sanctions regime and what drives their decision. Second, we discuss the impact of these strategies on the effectiveness of sanctions.

The paper is organised as follows: we begin with theoretically framing sanctions as potential sources of both political risk and economic opportunities. Based on the resource-based view, resource



dependence and institutional theory, we then develop a conceptual framework that captures the impact of sanctions on business operations. The theoretical part is followed by the analysis of data on companies' adjustment strategies in response to the EU sanctions against Russia collected through an anonymous survey (CAWI method) that we have conducted among British, French, German, Italian and Polish companies. We identify, analyse and discuss both firms' adjustment strategies as well as the reasons behind them. Therefore, we disentangle the binary point of view—compliance versus non-compliance—into more detailed strategic responses of companies to sanctions, what allows us to discuss the political implications of these strategies in the last section. We argue that the effects of defying sanctions limit the possibility of further sanctioning efforts and may even outlast the lifting of these restrictive economic measures.

## 2 | SANCTIONS AS A POLITICAL RISK AND AN ECONOMIC OPPORTUNITY

Sanctions typically aim to raise the costs of the target's transactions and, through this burden, cause or reinforce a change in behaviour. However, these measures also create economic costs for sender countries as they restrict activities of their domestic actors in the target country (Farmer, 2000). Despite the costs for imposing sanctions, policymakers can value the political and social benefits of sanctions higher than possible economic losses. But even though the sender government 'believes that sanctions on the target are in its interest, sanctions are not necessarily in the interest of the sender's domestic actors [... and] may in fact conflict' (Morgan & Bapat, 2003, p. 66). So sender governments need to deter their domestic actors from doing business with the target by enforcing sanction laws and penalising misconduct.

When it comes to investment decisions, *political risk* is an important determinant. Shotts (2016, p. 58) defines political risk as 'the possibility that a government will change its policies in some way that is detrimental to a firm's profits [...] after a company has made up front investments'. The possibility that sanctions are imposed thus constitutes a political risk (see also Sottilotta, 2016). A strand of literature analyses the impact of political risk in the form of sanctions on foreign direct investment (Biglaiser & Lektzian, 2011; Lektzian & Biglaiser, 2013, 2014; Mirkina, 2018). Our goal is to transfer these insights to more general business activities. Even bilateral trade, for example, needs an upfront investment to establish reliable commercial relations. Companies thus take political risk for this decision into account, too.

The impact of sanctions on companies' activities results, among other things, from the way firms perceive the uncertainty and risk associated with the restrictive measures. Uncertainty regards both the nature and scope of the sanctions' impact on the company's performance (due to a general economic downturn) as well as the duration and development of the sanctions dispute—and affects all companies' business relations with the target country, regardless of whether the company is directly targeted by the sanctions or not. Lektzian and Biglaiser (2013, p. 67) propose that 'sanctions imposed by a hegemon raise risk perceptions for global investors and lower global FDI flows to the target'. We transfer this argument to companies in sender states: the increased risk for global investors when a hegemon imposes sanctions equals the increased risk for all domestic economic actors in a sender state when only sectoral sanctions are imposed. Due to increased uncertainty and political risk, companies that operate in a sanctions regime thus have to pay a 'risk premium on economic interaction [...] even with respect to activities not directly covered by sanctions' (Noland, 2008, p. 2).

Additionally, firms can be indirectly affected by sanctions when their trade and supply chain partners, or financing institutions are targeted. Sanctions then create market frictions and raise the

administrative costs to prove compliance. In fact, *overcompliance* is a typical phenomenon for companies that hesitate ‘to invest in the complex due diligence required to ensure that their [...] counterparts are not linked to sanctioned entities’ (Johnston, 2015). Companies, once having perceived sanctions as directly or indirectly affecting them, will develop respective adjustment strategies.

Besides increasing the political risk, sanctions also create several opportunities for businesses. When sanctions are imposed and targeted firms comply with these measures and reduce their investments, the return to capital in the target country *ceteris paribus* increases in all sectors (Kaempfer & Lowenberg, 2007). Considering global FDI, Lektzian and Biglaiser (2013) develop an *opportunity* argument as a competing mechanism to the increased political risk: when the United States imposes sanctions, it cannot force third state actors to refrain from investing there and foreign investors replace US investments.<sup>1</sup> Similarly, for both unilateral and multilateral US sanctions, Yang, Askari, Forrer, and Zhu (2009, p. 1,240) show that there is a ‘gradual takeover of trade activities (especially imports) by EU members who were not participating in the sanctions’. The economic opportunity thus outweighs the political risk for foreign investors. Once again, we apply this logic for domestic economic actors in sender states when sectoral sanctions are imposed; while these measures create political risk, disinvestments from targeted firms increase the return on capital in non-sanctioned areas.

In addition, as Biglaiser and Lektzian (2011, p. 535) note: ‘targeted nations under sanctions are likely to provide economic goodies to attract FDI’. This strategy is consistent with the general literature on political risk, which suggests that short-run profits need to be sufficiently high for companies to invest in a risky environment (Shotts, 2016). With regard to the EU sanctions against Russia, the Regulation of the Russian Federation Government No. 708 (‘On special investment contracts for certain industries’) that came into force in July 2015 offers incentives for firms to invest.<sup>2</sup> Russia thus follows a carrot-and-stick approach: it bans certain imports from countries that have imposed sanctions against the Russian Federation, but at the same time incentivises firms from these countries to invest and localise their production.<sup>3</sup>

### 3 | COMPANIES’ BEHAVIOUR IN A SANCTIONS REGIME

The imposition of sanctions introduces additional political risk, a factor that deters trade and foreign investment. However, this conclusion does not always hold. While Biglaiser and Lektzian (2011) find that US companies reduce their investment in target countries prior to the imposition of US sanctions,

<sup>1</sup>Even though the United States try to deter third countries from economic exchange with certain target countries by introducing secondary sanctions, Lektzian and Biglaiser (2013, p. 71) conclude that ‘the United States cannot effectively punish foreign firms’.

<sup>2</sup>Foreign companies of certain industrial sectors, which invest at least RUB750 million (around EUR10 million) and commit themselves to stay in the market for up to ten years, can sign a special investment contract. These firms thereby become part of the Russian public procurement system and eligible for additional incentives (e.g., tax reductions and subsidies), which offer them a competitive advantage over firms that lower their engagement in Russia. Since these long-term contracts contrast with isolating Russia and reducing the activities of European companies on the Russian market, Russia itself incentivises EU companies to publicly oppose a reduction of economic exchange because of the sanctions. The German manufacturer of agricultural machinery, Claas KGaA, on 17 June 2016, was the first company to sign the special investment contract and therefore received the status of a ‘Russian manufacturer’ (Claas Group, 2016) – and Daimler’s investment for the new production plant was also made within this framework (Ballin, 2019).

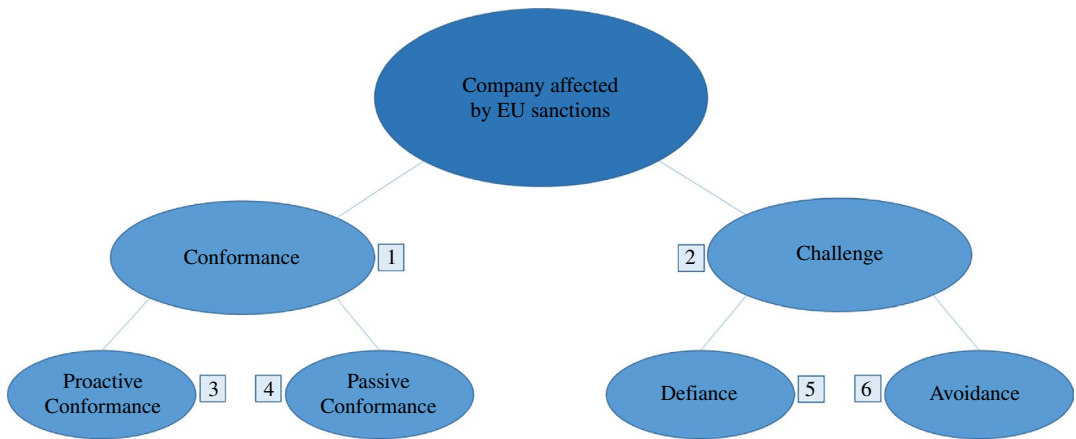
<sup>3</sup>The reason for this ban seems to be both political and economic; the latter is the attempt to make the Russian food industry more self-sufficient while keeping the main EU competitors at bay (Pospieszna, Skrzypczyńska, & Stępień, 2019).

one also needs to consider a temporal dimension: 'once sanctions are in place, lowered costs as a result of greater information about investment prospects and higher benefits that potentially accrue to investors may lead to reinvestment' (Biglaiser & Lektzian, 2011, p. 535). By contrasting political risk with economic opportunism, Mirkina (2018) qualifies these earlier findings by showing that only high-cost measures significantly decrease FDI in the short run. Lektzian and Biglaiser (2013) also show that, for third-party investors, the opportunity argument prevails when the United States have imposed sanctions. Moreover, targeted sanctions create economic opportunities for companies to invest in non-sanctioned areas and target countries incentivise firms to attract foreign investments.

We argue that these mixed results are due to an overgeneralisation of the effects driven by the competing mechanisms. Political risk and business opportunities both matter in a general sense—still, it is not clear when, at the micro-level, a company values the risk higher than the opportunity or vice versa. The perception of uncertainty and respective strategic choices vary among companies. Multinational enterprises might be more involved in the sanctioning process (and in closer contact to policymakers) such that they are better able to anticipate whether they will eventually be targeted. In contrast, small and medium-sized companies are less able to correctly interpret the political situation and therefore prone to react as if they were targeted. The question when one or the other mechanism prevails is thus best tackled at the firm level. To answer the question how domestic companies in sender countries evaluate the costs and benefits of increased political risk and new business opportunities, we first consider which kind of adjustment strategies firms can pursue at all.

Meyer and Thein (2014) explore how multinational enterprises reacted to the sanctions against Myanmar. They identify three strategic responses: *business as usual/entry*, *low profile strategies* and *disengagement*—depending on reputation risk, the size of the business opportunity and non-recoverable investments in the sanctioned country. Since this is the only study that considers more nuanced responses to sanctions than compliance and non-compliance, we draw on more general insights from the business literature. Our conceptual framework differentiates between conforming with and challenging sanctions. This distinction corresponds to the traditional classification of compliance and illegal evasion of sanction laws. However, since we are not only interested in companies targeted by sanctions but generally affected by a sanctions dispute, we use *Conformance* and *Challenge* as non-legal terms. It is not a matter of legal compliance how non-targeted companies that operate in sanctioned markets react, but still they have to decide whether to reduce their activities on the target's market.

In the next step, we disentangle both strategies. While *Conformance* includes reducing activities on the sanctioned market, freezing of investments, hibernating, as well as establishing new markets, *Challenge* accounts for both legally increasing activities in the sanctioned country as well as avoiding sanctions through legal loopholes. Oliver (1991) analyses general strategies how companies cope with institutional processes: *acquiesce*, *compromise*, *avoid*, *defy* and *manipulate*. Following this classification, we disentangle *Challenge* into *Defiance* (i.e., increasing investments in the sanctioned country and localising production there) and *Avoidance* (i.e., evading sanction laws by, e.g., exporting to the sanctioned country via third-party states). *Avoidance* can be both the use of legislative loopholes and a potential illegal action to evade sanction laws. However, when companies legally increase their engagement in non-sanctioned areas despite an established sanctions regime, they do not violate any regulation. We regard *Defiance* as de jure complying with but de facto challenging sanctions. The strategy of legally increasing the engagement in Russia, for example, runs counter to the idea of changing the political elite's behaviour through hurting the Russian economy. Finally, we split *Conformance* into *Proactive Conformance* (i.e., establishing new markets and relocating activities) and *Passive Conformance* (i.e., reducing activities on the sanctioned market and using cash reserves to hibernate). Figure 1 displays the hierarchy of the different adjustment strategies, and Table 1 shows the specific underlying measures, which companies could have potentially undertaken and which we associate with certain strategies.



**FIGURE 1** Typology of companies' adjustment strategies in a sanctions regime [Colour figure can be viewed at [wileyonlinelibrary.com](http://wileyonlinelibrary.com)]

#### 4 | THEORETICAL FRAMEWORK

How do companies choose a specific strategy? First of all, both sender country and target country institutions shape the economic environment in which companies operate (North, 1990; Scott, 2014). The role of institutions is to order and structure economic interactions by delineating the limits of permissible and unacceptable behaviours. Institutional theory defines sanctions as formal rules that aim to raise transaction costs of companies in the target country, even at the expense of domestic economic actors. However, sender governments have only a limited, mostly legal impact on their companies' behaviour. So sanctions' effectiveness depends heavily on the precision and explicitness of their content—and on the enforcement of imposed measures (Bapat & Kwon, 2015; Morgan & Bapat, 2003). When the legal enforcement is limited, sanctions' conformance can be increased through a public consensus on the imposition of punitive measures against the respective government. Sanctions, socially approved, gain the status of an informal institution for which breaking can also lead to social condemnation. However, while sanctions narrow the spectrum of possible operations within the restricted area, they often leave several options for companies. The limited scope of the EU sanctions against Russia is a prime example. Since the formal execution can only refer to areas where the restrictive measures apply, all activities of players that aim at continuing business with companies from target countries—and which might hamper sanctions effectiveness but are not strictly forbidden—are outside the scope of legal control. If sanctions leave room for using legislative loopholes, some companies will use them, especially when administrative burdens are not too high. In this regard, companies also take target country institutions into account. However, which strategy a company will pursue, in turn, depends on company characteristics that determine how to operate within a given economic environment.

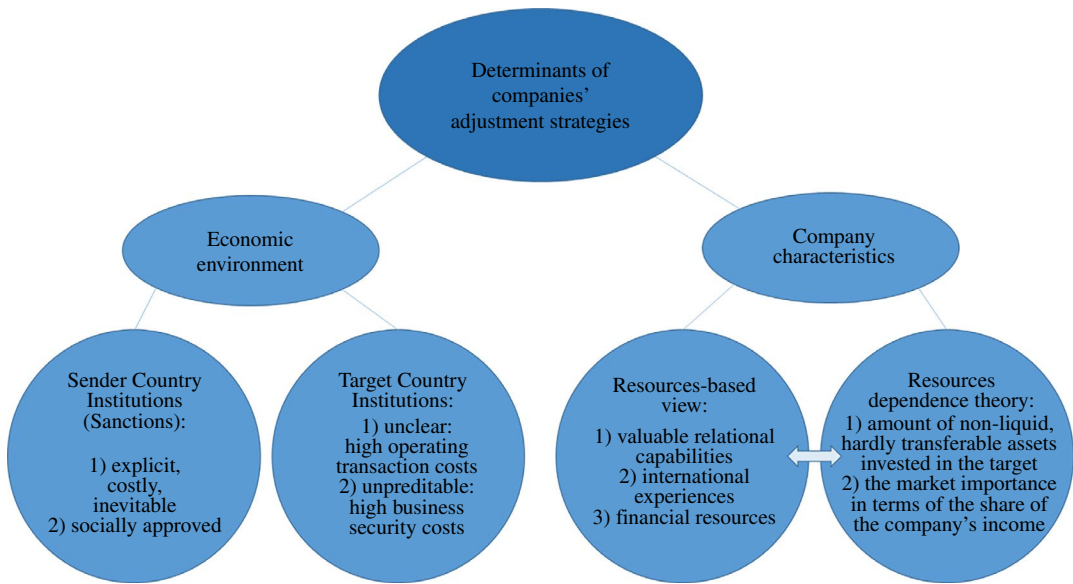
Enterprises exist to maximise their value in the long run—and this goal can be achieved thanks to a suitably selected strategy, using internal resources and external relations to ensure a long-term competitive advantage on the market (Barney, 1991; Oliver, 1991; Porter, 1980). First, the nature of the solutions used so far in similar conditions determine the strategies for coping with changes in the economic environment. This *resource-based view* focuses on companies' experience in operating on markets with diverse institutional settings and the length of the cooperation with business partners, including those from target countries. Second, *resource dependence theory* establishes that business

**TABLE 1** Measures linked to respective adjustment strategies (as presented in the online survey)

<b>1. Conformance</b>	
We established new export markets	} <b>3. Proactive Conformance</b>
We relocated activities to non-embargoed countries	
<b>2. Challenge</b>	
We left the Russian market	} <b>4. Passive Conformance</b>
We wound down some of our activities	
We sold off parts of our infrastructure	
We withdrew from investments	
We reduced our workforce	
We used cash reserves to hibernate during the sanctions	
We froze investments for the sanction period	
<b>5. Defiance</b>	
We increased investments in Russia	} <b>5. Defiance</b>
We moved our production to Russia	
We shifted the production to subsidiaries in Russia	
<b>6. Avoidance</b>	
We exported to Russia through third non-embargoed countries	} <b>6. Avoidance</b>
We re-exported products to Russia after processing them in third countries	

strategies depend on the strength of the companies' links to the sanctioned market. The scale of mutual business relationships (measured, e.g., by the scale of FDI, revenues from the target's market, or the strategic importance of purchases) will boost the determination of enterprises to maintain business relationships at a similar level or even increase them. The determination, however, can be constrained by the level and nature of the firms' resources—so both the resource-based view and resource dependence theory depend on each other. Figure 2 illustrates these determining factors of companies' adjustment strategies in comparison with the economic environment that is shaped by institutions.

According to the resource-based view, firms consist of resources, which determine their competitive advantage and their long-term performance. Sustained competitive advantage of the firm derives from resources (that the firm either possesses and/or controls) that are valuable, rare, imperfectly imitable and not substitutable. Resources are both assets and capabilities available and useful for



**FIGURE 2** Determinants for companies to comply or challenge sanctions [Colour figure can be viewed at [wileyonlinelibrary.com](http://wileyonlinelibrary.com)]

detecting and responding to market opportunities or threats (Wade & Hulland, 2004). Taking into account the turbulent nature of an economic environment, companies have to develop so called dynamic resources and capabilities that help to adopt proactive strategies and to react ‘sooner, more astutely, or more fortuitously’ to environmental changes in comparison with other companies’ responses (Eisenhardt & Martin, 2000, p. 1,117). Firm size, international scope of operations (and acquired knowledge to react accordingly to changing conditions), as well as the cooperation experience are good ways to accumulate such an agile capability to operate in a turbulent economic environment (Khanna, Palepu, & Bullock, 2010; Oliver, 1991). Sanctions are such a sudden change: they alter the institutional framework and constitute a legal constraint. Based on the resource-based view, we derive our first set of hypotheses:

**Hypothesis 1:** *A company’s ability to adjust and make a beneficial use of the new institutional framework is more likely, (a) the larger the size of the company, (b) the greater its international experience.*

Resource dependence theory (RDT) considers a company as an open system that strives to reduce the environmental uncertainty (Pfeffer & Salancik, 1978). The central concept for RDT is power perceived through the lenses of control over resources. Organisations attempt to reduce others’ power and increase their own power over others (Hillman, Withers, & Collins, 2009; Ulrich & Barney, 1984). However, empirical research in the field of companies’ reactions to political shifts is scarce. While companies can benefit from exerting power within their supply chain or within the networks they operate due to their competitive, mostly resource and knowledge-based importance in such relationships (Baker, 1990; Collins & Burt, 2003), they have a limited influence on reducing uncertainty regarding government policies. Some research reports that large, mostly multinational companies actively seek to ‘create’ new institutional rules that produce a more favourable environment by lobbying host country governments (Hillman & Wan, 2005; Kwok & Tadesse, 2006; Nebus & Rufin, 2010) and try to influence the design of sanctions





through lobbying efforts (Hufbauer, Schott, & Elliott, 2007; McLean & Whang, 2014). However, once sanctions are in force, even the biggest players cannot neglect formal restrictions. The strategic adjustment is a derivative of the impact that sanctions have on their survival and development—and their strategic options for compensating losses with alternative, non-sanctioned business opportunities. Sanctions thus pose a greater threat to enterprise existence, the more dedicated assets invested in the sanctioned market and the greater the percentage of revenues generated there, which cannot be quickly compensated by the redirection of sales or increasing revenues from other operations. Our second set of hypotheses refers to the implications of resource dependence theory on companies' adjustment strategies when operating in a sanctions regime:

**Hypothesis2:** *Companies are less likely to reduce their activities in a sanctioned country and conform to sanction laws, (a) the greater the FDI investment in the form of dedicated assets, (b) the larger the share of the revenue from the sanctioned market, and (c) the smaller the cash reserves that can be used to compensate short-term losses.*

## 5 | EMPIRICAL ANALYSIS

In 2017, an anonymous online company survey was conducted with a specific focus on the sanctions regime in the context of the Ukraine crisis. A back-to-back translated local language e-questionnaire was distributed in France, Germany, Italy, the United Kingdom (the 'big four' EU member states) and in Poland (the strongest voice of new EU members). The online survey consisted of 25 questions on the companies' metrics, the impact of the EU sanctions against Russia and the impact of the Russian countersanctions. The questions referred to the situation of the company prior to the imposition of sanctions, the impact of both types of sanctions, as well as the adjustment strategies that the companies have undertaken. In this paper, we focus on the impact of the EU sanctions and respective adjustment strategies.

### 5.1 | Factual background: The EU-Russian sanctions regime

Pro-Russian unrest in Eastern Ukraine and the annexation of Crimea by the Russian Federation followed the Ukrainian revolution of February 2014. The turmoil in the Donbass region escalated into an armed conflict between Russian-backed rebel groups and Ukrainian government forces. In March 2014, the European Union imposed the first sanctions against Russia in view of the violent situation in Ukraine: travel bans and asset freezes against individuals threatening the territorial integrity of Ukraine. Still, the conflict between Russia and Ukraine continued and in July and September 2014, the EU further imposed financial sanctions (limiting the access of Russian banks and companies to EU primary and secondary capital markets), an arms embargo (banning trade in arms and exports of dual-use goods for military use or military end users), and trade restrictions for technologies and services used for oil production. Over the past years, there has been a gradual extension of these sanctions. The EU constantly declared further persons and entities to be subject to asset freezes and travel bans. In March 2015, the EU linked the relaxation of the trade sanctions to the complete implementation of the Minsk agreement. Given that the agreement has not yet been fully implemented and there is no improvement, which justifies a change in the current sanctions regime from the EU's perspective, all restrictive measures are still ongoing (as of April 2020).

As retaliatory countersanctions, in August 2014, Russia prohibited the import of agricultural products from countries that have imposed or joined sanctions against Russia. The restrictions cover, *inter alia*, meat and meat products, fish, seafood, milk and dairy products, as well as fruits and vegetables.

## 5.2 | Sample characteristics

The Amadeus company database was used to obtain e-mail addresses from enterprises in a broad range of industries: around 59,000 e-mail addresses from companies in the United Kingdom, 40,000 for Germany, 33,000 for France, 27,000 for Poland and 17,000 for Italy. A local language cover letter announcing an academic survey on trade relations with Russia with a link to the online survey was sent twice to each company between April and June 2017. The survey data set contains 1,028 company responses (510 from Germany, 175 from Poland, 152 from the United Kingdom, 97 from France and 94 from Italy). While we are aware of the low response rate, we think it is fair given that the survey's topic is very sensitive and no incentives were offered (see also Cook, Heath, & Thompson, 2000 as well as Baruch & Holtom, 2008).

Although nearly half of all responses come from German companies, the shares of companies from France, Italy, Poland and the United Kingdom are rather similar. Figure 3 displays the distribution of the countries of origin and the share of companies that indicate to be affected by either type of sanctions for each country. The share of companies affected by the two types of sanctions is rather similar for Germany, France and Italy: around 25% of the respondents indicate that they have been affected by the EU sanctions against Russia and 10% indicated that they were affected by Russian countersanctions. The shares differ for Polish companies, which indicate that they are much more often affected by EU and Russian sanctions, and British companies that seem to be affected less often.<sup>4</sup>

Besides categorising respondents by country, we can differentiate them by sectors (Figure 4). The survey was sent to general production industries (cars, car components, production of machinery, etc.), the chemical and pharmaceutical industry, the food and agricultural industry, as well as non-food consumer goods because these are the industries with the strongest links to Russia and thus most likely to be affected by the sanctions. Most companies belong to the machinery industry (311 responses). Additionally, there are 189 and 86 respondents who belong to other production industries and the car industry, respectively. Around one third of the respondents in this group indicate that they have been affected by the sanctions against Russia. In comparison, only four of the 38 respondents from the pharmaceutical industry indicate that they have been affected by the EU sanctions. Finally, the survey data set contains 92 respondents from the agri-food industry as well as other food and non-food consumer goods industries (together 176 responses). The sum of all sectors exceeds the number of total responses because respondents were allowed to select several branches.

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<sup>4</sup>We do not claim that the share of companies affected by either type of sanctions is representative for the universe of enterprises in Europe. The smaller share of companies that perceive to be affected in the United Kingdom is, for example, likely to be misleading because we did not send the survey to companies in the financial industry (most likely to be affected there) because our adjustment strategies are related to actual production industries. On the other hand, the relatively high share of companies affected by sanctions in Poland may be a result of the strong public awareness of the negative impact of the Russian countersanctions on the Polish agricultural sector. We consider, however, this selection not as a major problem since we do not study the overall impact of sanctions on European companies but the grounds and varieties of companies' adjustment strategies when operating in a sanctions regime, irrespective of whether they belong to a certain industry or are located in a certain country. Our sample and the variation in key explanatory variables are large enough to provide explanations for how companies adjust because of the sanctions—and we find that their strategies are in line with our theoretical framework.

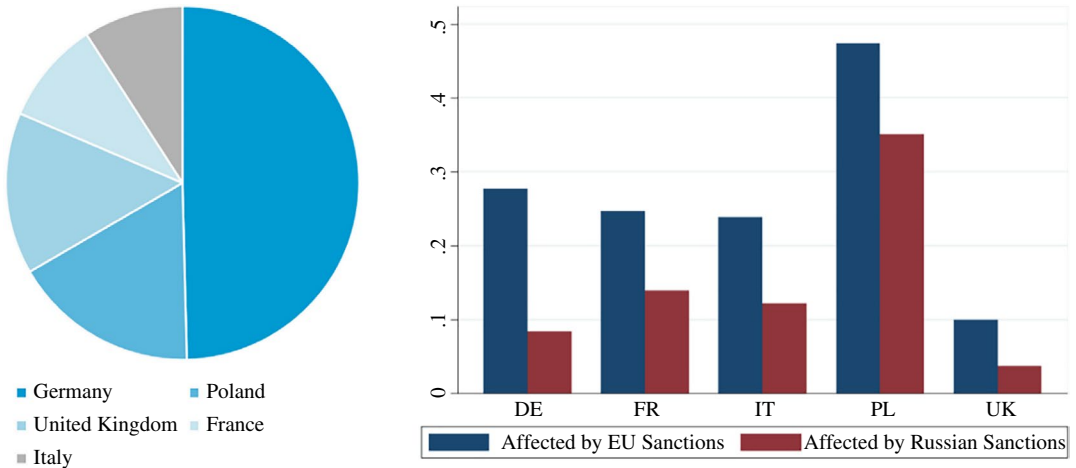


FIGURE 3 Share of sanction-affected companies by sanction type and country [Colour figure can be viewed at wileyonlinelibrary.com]

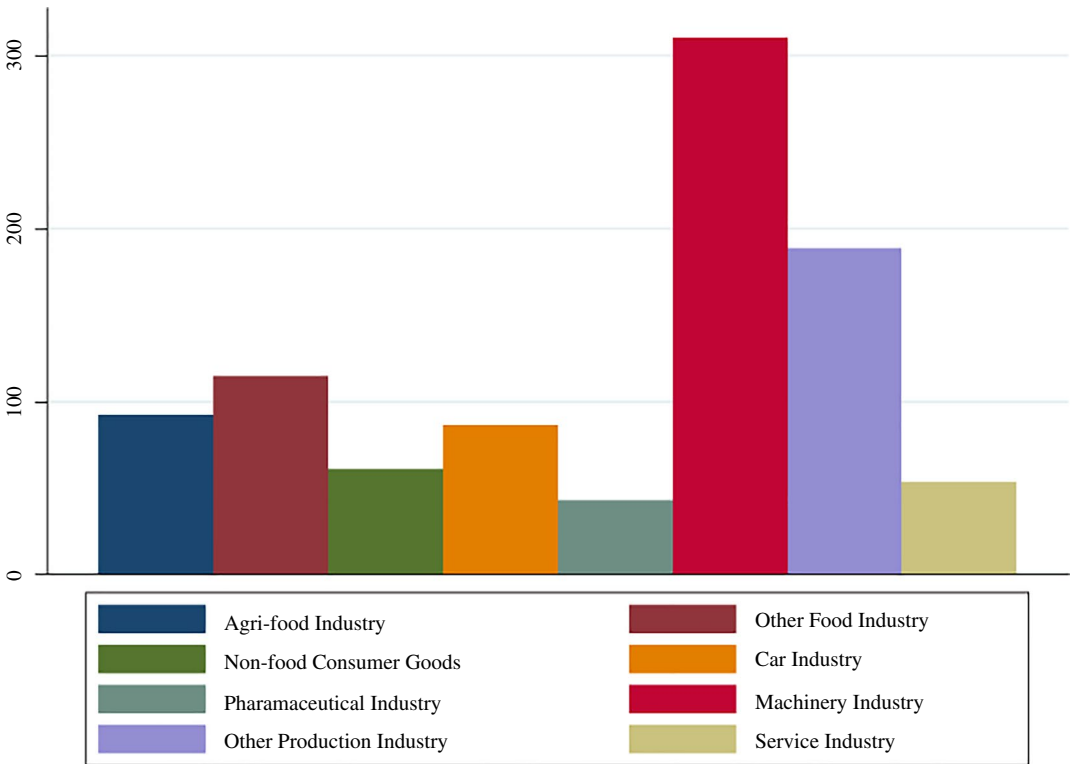


FIGURE 4 Number of responses by sector [Colour figure can be viewed at wileyonlinelibrary.com]

### 5.3 | Methods

The survey did not mention any of the broader adjustment strategies that we consider in this paper. Instead, companies that have indicated to be affected by the sanctions saw specific measures, which they could have potentially undertaken in response to the sanctions (Figure 1). For each activity, the respondents could tick whether they have adopted the respective measure.

TABLE 2 Conformance and challenge by EU companies

Conformance	Challenge		Total
	0	1	
0	22	1	23
1	111	58	169
Total	133	59	192

### 5.3.1 | Dependent variables

Six dependent variables account for the two main strategies (*Conformance* and *Challenge*) and the four sub-strategies (*Proactive conformance*, *Passive conformance*, *Defiance* and *Avoidance*). Each dependent variable is a dummy, which becomes one when the respondents ticked that their company has undertaken at least one of the measures that belong to the respective strategy. Table 2 displays the number of companies for both the *Conformance* and *Challenge* strategy. There are 264 respondents who indicate to be affected by the EU sanctions against Russia. Around one third of them (72 respondents) do not disclose which adjustment strategies they have undertaken. Over 40% of the respondents indicate to have adopted only *Conformance* measures and about 20% of the affected companies declare to have undertaken measures related to both the *Conformance* and *Challenge* strategy (58 respondents). There is just one respondent who has only ticked *Challenge* strategies. Of all companies that have adopted a *Challenge* strategy, 31 companies indicate to have either re-exported products to Russia after processing them in third countries or exported them through third non-embargoed countries (*Avoidance*), 13 companies shifted their production to Russia or increased their investments otherwise (*Defiance*) and 15 companies did both. Though most companies in our sample conform to the sanctions, a considerable number of firms also challenge them in some way. In the next step, we aim to explain when companies choose which strategy.

### 5.3.2 | Independent variables

We include six independent variables that capture the main aspects of our theoretical framework: firm size, international experience, own entities in Russia, market dependency, cash reserves and administrative burdens (for activities in Russia). We provide tables with summary statistics and a matrix of correlations in the Appendix S1.

To measure the size of the firm, respondents had to select an interval that contains the number of employees in their firm (less than 25; 25–100; 101–250; 251–500; more than 500). We created three dummy variables—small firm (less than 25), medium firm (25–250) and large firm (more than 250 employees)—and include the dummies for medium and large firms in the regression to account for firm size.<sup>5</sup> Next, we employ item response theory and estimate a rating scale model including two ordinal variables: the number of foreign markets in which the firm operate (1; 2–4; 5–9; 10 or more) and the number of years they have operated in these foreign markets (less than one year; 1 up to 3 years; 3 up to 10 years; more than 10 years). Based on this model, we predict values for our variable

<sup>5</sup>The intervals for medium and large firms correspond to the classification by Eurostat: <https://ec.europa.eu/eurostat/web/structural-business-statistics/structural-business-statistics/sme>.



measuring international experience. Firm size and international experience capture a company's internal ability to adjust derived from the resource-based view (hypothesis 1).

Own entities in Russia is a binary variable, which becomes one when the respondents ticked that they have own factories or farms in Russia. Market dependency, cash reserves and administrative burdens are ordinal variables based on Likert scales for which respondents had to indicate whether the dependency on the Russian market (i.e., sales and revenue as well as general business strategies depend mostly on the demand from Russia), internal cash reserves (i.e., sufficient money or highly liquid investments to cover short-term and emergency funding needs), and administrative burdens for activities in Russia (i.e., new certificates, documents, procedures change etc.) were either very low, low, normal, high or very high. We code these variables from 1 to 5. Own entities in Russia, market dependency and cash reserves capture the implications of the resource dependence theory (hypothesis 2). In addition, we control for administrative burdens because target country institutions can enable or constrain companies' adjustment strategies.

### 5.3.3 | Regression models

For the inductive statistics, we run multinomial logistic survey regression models with linearised variance estimation that is robust for complex survey data. However, we do not have a stratified design because the e-mails were sent to all companies of the chosen sectors in the five EU countries listed in the Amadeus database.

## 5.4 | Results

In our first model, we contrast the decision to conform to the decision to challenge sanctions. Since there is only one respondent who indicates to have adopted only measures related to the *Challenge* strategy, we regard companies that have only undertaken *Conformance* strategies in comparison with companies that have adopted measures from both the *Conformance* and the *Challenge* strategy. In this model, *Conformance* is the base outcome.<sup>6</sup> We present the results in Table 3.

We find that own entities in Russia as well as market dependency increase the likelihood for a mixed *Conformance* and *Challenge* strategy (at the level of 5 and 1%, respectively). Both independent variables provide evidence for our second hypothesis that dedicated, non-fungible assets as well as a company's dependency on the sanctioned market make companies less likely to reduce their activities in the sanctioned country and conform to sanction laws. In contrast, administrative burdens for activities in Russia make companies less likely to challenge the sanctions: the coefficient for adopting a mixed *Conformance* and *Challenge* strategy is negative and significant at the 5% level—so costly institutional settings in the target country make companies more likely to reduce their activities there. The coefficients are jointly significant at the 10% level.

In the next step, we disentangle *Challenge* strategies into *Defiance* and *Avoidance*. Again, we set *Conformance* as the base outcome because most respondents chose this strategy. We compare this baseline strategy to any combination of this strategy with the two different *Challenge* strategies and present the results in Table 4, which is one single multinomial logistic regression model with four outcomes. The coefficients of the model are jointly significant with a p value of zero. Since the adoption

<sup>6</sup>Since there are only two outcomes in Table 3, the multinomial model essentially boils down to a logit model in which the 'positive' outcome is the adoption of some kind of *Challenge* strategy.

TABLE 3 The decision to challenge

	Observations	93
<b>Multinomial model with two possible outcomes</b>	<i>F</i> statistic	<b>1.992</b>
	p value	<b>0.065</b>
	(1)	(2)
<b>Variables</b>	<b>Conformance (base outcome)</b>	<b>Conformance AND challenge</b>
Firm size		
Medium company		−0.353 (0.578)
Large company		0.009 (0.778)
International experience		0.368 (0.465)
Own entities in Russia		1.951 <sup>***</sup> (0.913)
Market dependency		0.593 <sup>***</sup> (0.209)
Cash reserves		−0.146 (0.227)
Administrative burdens		−0.513 <sup>***</sup> (0.248)
Constant		−0.133 (1.120)

Notes: Standard errors in parentheses.

\*\*\* $p < .01$ ; \*\* $p < .05$ ; \* $p < .1$ .

of a strategy is drawn with respect to alternative strategies, we think that multinomial models are the appropriate choice. As a robustness check, we also run survey logit models with linearised variance estimation on every individual adjustment strategy. The results in the Appendix S1 are robust to this alternative model specification.

When differentiating between the two forms of challenging sanctions, we find that market dependency makes it always more likely to adopt any combination of *Challenge* strategies, while administrative burdens make it always less likely to adopt such a strategy (the coefficient is marginally significant for combinations of strategies including *Avoidance*). Both increasing exchanges with Russian partners and using the grey area of sanctions evasion are strategies that are based on uncomplicated and unbureaucratic transactions (i.e., target country institutions). Own entities in Russia have a significant negative effect at the level of 1% on the combination of *Conformance* and *Avoidance* but a positive and significant effect (at the 1% level) for the combination of *Conformance* and *Defiance*. The coefficient is not significant for the combination of both kinds of *Challenge* strategies. This result shows that companies, which are directly engaged in Russia and have non-fungible assets there, oppose sanctions but are unlikely to engage in any potential illegal behaviour as they do not want to jeopardise their whole business by getting caught for illegal business transactions. So in line with

TABLE 4 Disentangling challenge strategies

Multinomial model with four possible outcomes		Observations		93
		(1)	(2)	(3)
Variables	Conformance (base outcome)	Conformance and avoidance	Conformance and defiance	Conformance and defiance and avoidance
Firm size				
Medium company		-0.608 (0.736)	0.591 (0.901)	-0.533 (0.962)
Large company		-0.417 (1.032)	0.784 (1.661)	0.313 (1.009)
International experience		0.494 (0.594)	-0.0935 (0.647)	0.567 (0.690)
Own entities in Russia		-12.76*** (0.896)	3.234*** (1.085)	1.412 (1.331)
Market dependency		0.540*** (0.295)	0.576*** (0.263)	0.667*** (0.342)
Cash reserves		-0.0374 (0.289)	-0.360 (0.235)	-0.101 (0.310)
Administrative burdens		-0.467*** (0.268)	-0.389 (0.383)	-0.731*** (0.414)
Constant		-1.045 (1.132)	-1.985 (1.776)	-1.011 (1.987)

Notes: Standard errors in parentheses.

\*\*\* $p < .01$ , \*\* $p < .05$ ; \* $p < .1$ .

resource dependence theory, our previous model shows that companies which have own entities in Russia (i.e., dedicated, non-fungible assets) tend to challenge sanctions. However, when we disentangle *Challenge* strategies, we find that these companies do not avoid sanction laws but increase their activities in non-sanctioned areas (i.e., adopt a *Defiance* strategy).

While we expected cash reserves make companies less dependent on the sanctioned market and allow them to hibernate and wait until the sanctions are lifted, the effect is not significant. In comparison with the base outcome, the coefficient of cash reserves is negative for all other combinations of strategies. Even though companies that have more cash reserves are more able to hibernate, they tend to pursue other strategies determined by other factors if they have the chance. Moreover, we do not find evidence for our hypotheses based on the resource-based view; there are neither significant effects for firm size nor international experience.<sup>7</sup>

<sup>7</sup>We also estimate a model in which we compare the different *Conformance* strategies. We find that international experience has a positive effect for any combination of strategies including *Proactive conformance*. A company is more able to establish new export markets and relocate activities if it operates for a longer time on more foreign markets. However, since the focus of this paper is on *Challenge* strategies, we present these results in the Appendix.

In sum, market dependency and own entities in Russia (Hypothesis 2) make *Conformance* less and *Challenge* more likely. Institutional factors in the form of administrative burdens for activities in Russia have the opposite effect. However, we do not find evidence for the resource-based hypotheses. When companies challenge sanctions, they rather make a virtue of necessity than simply using the economic opportunity when they have the resources to do so.

## 5.5 | Discussion and limitations

There are three main caveats in our empirical analysis. One drawback is an anonymous survey that we were unable to determine which companies participated. Our findings do not serve as a representative analysis of the impact of sanctions on European companies. However, we collected information on companies that operate in the Russian market despite the EU sanctions and we have important variation in our variables of interest such that we are able to determine factors, which drive the business strategies of these companies after the imposition of sanctions. We are aware that respondents potentially refrained from saying everything they do if some actions might have legal consequences and given that *Avoidance* potentially constitutes an illegal behaviour. So we probably captured only a small share of all companies that engage in such a behaviour. But this bias runs counter to our effect such that we believe that our results regarding sanctions avoidance are conservative. In addition, we are not interested in quantifying *Defiance* and *Avoidance*, but in analysing the determinants for adopting these strategies.

Second, many respondents did not answer all questions such that we have to cope with missing data. Since there are only 264 respondents who indicate that their company has been affected by EU sanctions, the number of observations for our regression models cannot exceed this number of respondents (we only asked affected companies which kind of adjustment strategies they have undertaken). By including six explanatory variables, the number of observations drops quite quickly to less than 100 because of missing values. Still, even though the number of observations gets smaller because of the listwise deletion of observations with missing values (which is a hard test for our hypotheses since we have to find effects in a smaller sample), we find support for our hypothesis on resource dependency. Moreover, our analysis of missing values in the Appendix S1 shows that these data are missing at random.

A third drawback is that the responses are assessments and perceptions from company representatives. So we do not have hard data to quantify the impact of sanctions on the companies. We directly asked firms for adjustment measures that they have undertaken because of the sanctions, but we do not claim that they were not influenced by other macroeconomic factors (such as the decline of the oil price or the Russian ruble). We have obtained responses from companies both directly and indirectly targeted by the EU sanctions against Russia and we treat our respondents as being able to assess how they incorporate the risk and opportunities introduced by sanctions into their decisions, especially since sanctions are different from regular economic fluctuations and thus cause other business reactions (Knight, 2012).

## 6 | THE POLITICS OF CHALLENGING SANCTIONS

Since the literature on economic sanctions usually models sanctions as disputes between states, scholars often focus on third-party states, 'black knights' (Galtung, 1967), to explain the failure of sanctions (Early, 2015; Hufbauer et al., 2007). However, the problem of sanctions busting starts much earlier;





the incentive to hold up profitable trade and fill the vacuum of lost trade also exists for domestic firms in sender states. Policymakers can enact laws and regulations, but they cannot control business decisions. When sanctioned trade occurs despite the restrictions, sanctions can barely have an effect. With regard to the Western sanctions against Russia, the UK Treasury's Office of Financial Sanctions Implementation (OFSI) declared that 133 suspected breach cases, worth £1.4 (EUR1.56) billion, were reported in 2017 (HM Treasury, 2018). The US Office of Foreign Assets Control (OFAC) fined ExxonMobil, a US multinational oil and gas enterprise, US\$2 (EUR1.78) million for 'the signing of legal documents related to oil and gas projects in Russia with Rosneft, the Russian state oil company' (Rappeport, 2017). Sanctions avoidance also plays a role for the Russian countersanctions. In 2014, Russia investigated the smuggling of fruit and vegetables from the EU through Bosnia, not targeted by the Russian sanctions. 'In the first nine months of the year Bosnian exports of fruit and vegetables amounted to 3,123 tonnes compared with 1,014 tonnes in the same period last year' (Agence France Presse, 2014). Belarus, a landlocked country, increased its fish exports to Russia by nearly 100% (RBC Daily, 2014), helping Norwegian fish to find its way to Russia (The Moscow Times, 2014).

Morgan and Bapat (2003) as well as Bapat and Kwon (2015) claim that the effectiveness of sanctions depends on whether sanctioning states can deter their domestic actors from trading with the target. When the economic exchange with the target is important for firms in the sender countries, they are more likely to evade the restrictive measures, which implies that sanctions are most likely to be effective when trade links are moderately important for both economies. Once the economic interdependence is too high, sanctions are unlikely to be enforced, and when too low, the target's incentive to acquiesce is negligible. The negative impact of the evasion of sanctions on their effectiveness is thus well established in the literature. We shift the attention to the political implications of the *Defiance* strategy.

## 6.1 | Political implications of defiance

After a short period of deteriorating economic exchange between the European Union and Russia subsequent to the imposition of sanctions, trade relations recovered quickly. Irrespective of what has driven the decline of the Russian economy by almost 3% in 2015 (the year after the imposition), in 2016 it decreased to 0.2% and then economy recovered and grew by 1.5% in 2017, even though the sanctions were still in place. During that time, several EU companies increased their investments in Russia and even localised their production there. The institutional setting of the EU-Russian sanctions regime incentivised undertaking this *Defiance* strategy and diminished the real effect of the sanctions regime on the Russian economy, regardless of the EU's intended effects of the sanctions. Again,<sup>8</sup> in comparison with sanctions avoidance, the strategy of *Defiance* does neither violate the EU sanctions nor the Russian countersanctions, but this leeway has at least two side-effects of which policymakers might not be aware.

First, the strategy of *Defiance* changes the economic status quo and limits the choice set of policymakers as a further tightening of the sanctions becomes costlier. By increasing foreign direct investments, companies create facts, which set disincentives for policymakers to pursue a further tightening of the sanctions because economic linkages make sanctions both less likely to be imposed (Lektzian & Biglaiser, 2014) and less likely to be enforced (Bapat & Kwon, 2015). Politicians face a trade-off when

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<sup>8</sup>We do not claim that these developments necessarily run counter to what EU policymakers have in mind. For example, Christie (2016) argues that the narrow scope of the measures was purposely designed to have a limited real effect on the Russian economy to avoid a further escalation and to protect European business interests. At the opening ceremony of the new Daimler plant in Russia, the German Federal Minister for Economic Affairs, Peter Altmaier, confirmed this view by claiming that the sanctions are not about bringing Russia to its knees because a successful Russia is also in Germany's interest (ZEIT ONLINE, 2019).

it comes to the imposition of sanctions and are reluctant to jeopardise their own economic benefits (i.e., tax revenues) if too much is at stake for their domestic companies (McLean & Whang, 2014). Since September 2014, we could in fact only observe additional targeted sanctions, but no further extension of the trade restrictions—and opposition against the EU's sanctions regime within EU becomes louder. Second, *Defiance* strategies have long-term effects. Once firms decide to carry the costs of adjusting and to make investments in Russia, they will not easily and quickly revoke them—even when the sanctions are lifted. Additionally, once economic actors adjust to sanctions, these measures exert less pressure. In the empirical analysis, we show that some companies increase their engagement because of the sanctions. So irrespective of whether EU policymakers wanted to harm the Russian economy or only impose symbolic sanctions, they have to realise that the institutional setup led to increasing economic exchange and a shift of the production from the EU to Russia. This new economic equilibrium reduces their choice set during the sanctions dispute and will eventually even outlast the lifting of the sanctions.

## 7 | CONCLUSION

There are three important contributions of our paper. First, we differentiate between a broad set of adjustment strategies that companies undertake when they have to operate in a sanctions regime. Strategic options for companies to conform with or challenge sanctions are far more nuanced than a mere compliance or violation of sanction laws. The question on whether the political risk or economic opportunities induced by sanctions determine companies' reactions should be answered at the firm level by studying the grounds and types of their adjustment strategies. Companies are more likely to challenge sanctions when they are dependent on the Russian market. We show that several firms increase their engagement in non-sanctioned areas when their non-fungible assets are in danger. The impact of sanctions in the form of increased political risk thus encourages some firms to adopt measures related to this *Defiance* strategy when resource dependency makes it necessary to do so.

Second, we provide micro-level foundations and empirical evidence from sanction-affected EU companies for existing macro-level claims on sanctions effectiveness. Therefore, we introduce a survey data set, which contains more than 1,000 genuine responses from representatives of companies in France, Germany, Italy, Poland and the United Kingdom who have received our back-to-back translated local language e-questionnaire. To the best of our knowledge, this is the first scholarly company survey that focuses on the impact of sanctions and respective adjustment strategies.

Third, we discuss the political implications of the *Defiance* strategy, which is incentivised by the institutional setting of the EU-Russian sanctions dispute. This strategy is a promising way for companies to avoid the direct and indirect effects of sanctions without engaging in any illegal behaviour. While investing in non-sanctioned areas, companies do not violate any law, but at the same time reduce the target's costs of the restrictive measures. Moreover, after companies have paid the adjustment costs, they will not revoke their investment—even when the sanctions are eventually lifted. The new economic equilibrium, created by the build-up of *Defiance* strategies, will thus outlast the sanctions regime. So both scholars and policymakers should have these incentives in mind.

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## SUPPORTING INFORMATION

Additional supporting information may be found online in the Supporting Information section.

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