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Challenges of Implementing a New Legal System

By Richard Conn

The dissolution of the Soviet Union and creation of an independent Russian Federation presented the Russian leadership with the challenge of establishing the rule of law to support a nascent market economy in a country unfamiliar with either concept. This article examines the influence Russia's history has had on the emergence of its modern-day legal system and highlights key legal developments over the last decade, with particular emphasis on commercial law. The last 12 years have witnessed the Russian Federation make great strides toward designing and building the legal framework necessary to support a market economy. The fact that this framework has truly been assembled "from the ground up" makes these accomplishments event more noteworthy.

Historical Impediments

Post-Soviet Russia could not look to historical precedent to assist in creating a rule-of-law society to support its market economy. As one commentator noted: "There was not much real and coherent order and structure of a legal system under the Soviet regime, nor much more under the Czarist governments."¹ While the civil law system² in pre-Soviet Russia did share the same legal pedigree as continental European countries, its roots did not run deep. In fact, Western legal theory was not systematically received by Russia until the eighteenth and nineteenth centuries.³ Moreover, Russia's first parlia-

mentary institution, the State Duma, was not created until after the 1905 revolution. Shortly thereafter, in 1913, the Duma received the first codification of Russian civil law. This code was based on models of the civil codes of Western Europe, yet it was never enacted due to the 1917 revolution. Ultimately, the civil law tradition that began to take shape under the Czarist rulers became corrupted by the influence of Soviet ideology.

During the Soviet period, a new code was prepared in 1922 that represented the ideals of the Communist Party's New Economic Program. The 1922 Code remained in place until the adoption of the 1964 Code. Despite the fact that new civil codes were prepared during this time, the regime's isolation from Western ideas shielded the legal system from many of the twentieth century developments, such as constitutionalism and judicial review, that refined Western European civil law systems during that period.⁴ As a result, the Soviet legal system "reflected nineteenth century ideas that had long ago been discarded by Western European legal scholars."⁵

At its core, a free market economic system relies on its citizens' trust in the rule of law. The citizenry of post-Soviet Russia had a deep distrust of government structures and little respect for ownership rights in business. In addition to the obstacles posed by the lack of foundation or experience upon which to create a rule-of-law society, the absence of an established judiciary

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also hindered efforts to consistently enforce such laws. It was a tall order to expect the judiciary to adjudicate commercial matters with which it had almost no previous experience. This was all the more challenging given a history rife with favoritism and bribery.

Overall, the emergence of a new Russian legal system has been slow. "It is clear that reform of the Russian legal system will take many years. It is also clear that a total rejection of Soviet laws would have created serious gaps in legal regulation. As a result, all Newly Independent States (including Russia) have had to rely on the legislation of the former Soviet Union."⁶

Initial Steps Toward Reform

The foundation of civil legislation reform grew out of the 1991 drafting of the Fundamentals of Civil Legislation of the USSR and the Union Republics. The 1991 Fundamentals reintroduced many of the traditional concepts of civil law such as contracts and, while not providing comprehensive reform in this area, did remove the economic and political influences of Marxism that had separated the Russian legal system from its civil system brethren.

"[T]o a certain degree the preparation of the 1991 Fundamentals was similar to the restoration of old paintings. Numerous norms and institutions lost in the 1930s and 1960s—norms indispensable to the functioning of a market economy—needed to be restored. These losses in particular concerned the major actors of entrepreneurial activities—legal entities, such as commercial partnerships and societies. Layers of restricted principles and norms that had been introduced into civil law by the administrative-command system had to be removed."⁷

The 1993 Constitution

A major step toward the emergence of Russia as a rule-of-law state was the adoption of the 1993 Constitution by popular referendum. Prior to adoption of the 1993 Constitution, there were no real social, economic and political contracts

that represented a consensus in the newly emerged Russian Federation. Previously, President Yeltsin had used his decree powers extensively to introduce economic and legal reforms. In fact, the Constitution itself represented the culmination of a battle over legislative supremacy versus presidential prerogative, from which President Yeltsin emerged victorious.

One unfortunate blemish on the process that produced the 1993 Constitution was the lack of a "constitutional convention" that may have resulted in a consensus regarding the relationship among individuals, the regions and the federal government. As set forth in the 1993 Constitution, the Russian Federation is a state made up of subjects of the Federation, which include republics as well as certain territories, regions and cities. Subjects of the Federation have no right of unilateral secession.⁸ While a national referendum approved the Constitution, this procedure left undiscussed and unresolved critical issues that have continued to plague Russia, including taxation and the relationship of regions to the federal authorities.

Enactment of the Civil Code

Second only to the Constitution in stature amongst Russia laws, the 1994 Civil Code is considered the "constitution" of the Russian economy. The 1994 Civil Code repealed all prior civil laws and established a new market-oriented system. "It is not possible to overestimate the importance of this codification, which provides a coherent legislative framework for more than a hundred separate legislative concepts or ideas covering many aspects of business and commercial (and privatized) life."⁹

The Civil Code is divided into three parts. Part One of the Code entered into force on January 1, 1995, and includes the general principles of civil law, property rights and contract law. Part Two of the Code, which entered into force on March 1, 1996, addresses specific types of contracts and torts. Part Three of the Code entered into force on March 1, 2002 and includes inheritance law, intellectual property and

private international law. The Civil Code has also been supplemented by detailed legislation that further develops the general principles of the Code as applied to specific commercial activities. Included among such statutes are the 1995 Law on Joint-Stock Companies, the 1996 Law on the Securities Market, and the 1998 Law on Limited Liability Companies.

(1) Contract Law

One area in which the Civil Code has truly transformed the Russian legal system is contract law. "Compared to its pre-1991 version, modern Russian contract law can best be described as a total metamorphosis."¹⁰ Contract law in Russia is subsumed under the general law of obligations. From an organizational point of view, Part One of the Civil Code delineates the general law of obligations and lays the foundation for all aspects of legal relations and property rights covering contract law, tort law and unjust enrichment. Part Two of the Civil Code discusses specific forms of contracts.

The law of obligations is a civil law concept that describes a body of law that encompasses both common law contracts and torts. The law of obligations relies upon the concept of an obligational relationship between two parties: a creditor who is owed the performance of the obligation and a debtor who owes the performance of the obligation. Among others, the act underlying that obligation can be to transfer property, to perform work or to pay money.¹¹

Overall, Russian contract law is much more closely aligned with continental European contract law than Anglo-American common law. Thus, while the formation of a contract under Russian law is based on the familiar concepts of offer acceptance, consistent with continental law, no consideration is required to make a contract binding. Moreover, Russian contract law retains the civil law practice of the binding nature of an offer. In an additional departure from common law, Russian law insists upon the specific performance of obligations and the lack of any concept of liquidated damage for nonperformance of a contractual

obligation.¹² Instead, Russian contracts make liberal use of penalties, fines and forfeitures. The Civil Code also includes the pledge and mortgage as a means of securing performance. Finally, compared to Anglo-American law, Russian law relies more heavily on the written and notarized contracts.¹³

(2) Commercial Law and Organizational Forms

Unlike civil law countries such as France and Germany, Russia does not have a commercial code distinct from its Civil Code. Instead, Article 2 of the Civil Code states, "civil legislation regulates relations between persons involved in entrepreneurial activities or participating in them." In the Russian system, "[e]ntrepreneurial" is preferred to 'commercial', 'trade', or 'economic' law ... the aim of entrepreneurial law is to combine and integrate the public and private law aspects of economic life expressed in entrepreneurship, a philosophy and an aim which in the minds of most proponents presupposes a large, perhaps massive, dosage of state regulation of the economy."¹⁴ While entrepreneurial law is integrated into the Civil Code, the Code does include a number of special rules that apply only to entrepreneurs. For example, Article 401 imposes a higher standard of care on entrepreneurs participating in a civil transaction than is imposed on an ordinary citizen.¹⁵

Commercial organizations are separate judicial persons under the Civil Code and have civil law rights and duties. The Civil Code discusses both full partnerships and limited partnerships, as well as three types of companies. Full partnerships are formed and operated on the basis of a written agreement. Because all members retain unlimited liability, this organizational form is not popular and is mainly used in family businesses.¹⁶ Limited partnerships are a popular form of organization for small or medium businesses. The limited partnership is split into two groups: full partners who create the partnership through a written agreement and retain unlimited liability, and participant-investors who hold no risk other than their capital

contribution. There are no limits on the number of participant-investors in a limited partnership.

Companies under Russian law operate under the distinct advantage of limited liability. The three types of companies set forth under the Civil Code are the joint-stock company (known by its Russian acronym ZAO), the limited liability company (known by its Russian acronym OOO) and the additional limited liability company (known by its Russian acronym ODO).

The joint-stock company (ZAO) is by far the most popular enterprise form; it is regulated by the Civil Code and the 1995 Law on Joint-Stock Companies. There are two types of ZAOs—open and closed. Shares in an open ZAO are freely alienable and must publish financial information. Shares in a closed ZAO cannot be traded and may be distributed only among the founders. Closed ZAOs are not obligated to publish financial information, however, they may have only 50 shareholders. ZAOs may issue ordinary or preferred shares of stock and may also issue securities or bonds. The chief distinction of ZAOs from the American corporation is the elevated decision-making status Russian law affords the general stockholder meeting. In fact, many management prerogatives exercised by the board of directors of an American company are under the exclusive jurisdiction of a ZAO stockholder meeting.¹⁷

Limited liability companies (OOO) operate pursuant to a contract and charter. The additional limited liability company (ODO) is not very popular and is basically a form of OOO in which the members assume greater proportional liability. Both OOOs and ODOs are regulated by the Civil Code and the 1998 Law on Limited Liability Companies. The chief distinction between limited liability companies and the joint-stock company is the charter capital of an OOO is divided into participatory shares that are not securities, unlike the ZAO, whose charter capital is divided into stocks. An OOO also has a more flexible management structure. Like the closed ZAO, an OOO may have a maximum of 50

investors and is not required to publish information on the company's business or finances. A disadvantage is that an OOO does not have access to capital markets.¹⁸

Resolving Commercial Disputes

Within the Russian judiciary system, the Supreme Arbitrage Court is a specialized court of equal stature with the Constitutional Court and the Supreme Court. It is empowered to resolve commercial and economic disputes between public and private parties, including foreign parties. The Supreme Arbitrage Court is the forum of last resort for disputes filed in the arbitration courts, the branch of the judiciary that resolves the vast majority of commercial disputes in Russia. The arbitration courts themselves are former organs of the Soviet state that originally functioned as a hybrid arbitrator and adjudicator of disputes between state enterprises.¹⁹ The 1991 Law on the Arbitrage Court discarded the legacy of Soviet state arbitration and replaced it with a new system of arbitration courts in the reformed Russian judiciary. In 1993, the Constitution confirmed the arbitration courts' position as a branch of the judicial system.

Enactment of Tax Laws

The development of market-oriented tax laws has also played a key role in the transition to a market economy.²⁰ Russian law provides for taxation on the federal, regional and local levels.²¹ A problem throughout the decade of the 1990s was the lack of harmonization of tax systems across jurisdictional levels. Earlier in that decade, estimates for the cumulative rate of applicable federal and local taxes for one region were as high as 180 percent.²² This situation led to chronic underreporting and evasion.²³

Individual laws on VAT, excise and income tax were first introduced by the Russian Federation in late 1991. However, the first overall tax policy, the Law on the Fundamental Principles of Taxation in the Russian Federation, was enacted in 1992.

This law “marked the true transition ... of the Russian Federation toward using taxation not merely to raise revenues, but also to regulate social policy generally, regional policies, and local self-government.”²⁴ The 1992 law was superceded in 1999 by the Tax Code of the Russian Federation. Part Two of the Tax Code became effective in 2001. That legislation replaced the marginal rate structure for personal taxes with a 13 percent flat personal income tax, established a unified social tax that replaced separate benefit fund taxes, and increased excise taxes on gasoline and oil products.²⁵

In 2002, a chapter on the profit tax entered into the Tax Code. That codification reduced the overall profit tax rate from 35% to 24%. In addition to the drastic rate reduction, the Tax Code also moderated or eliminated previous restrictions on the deductibility of business expenses thereby aligning Russian corporate tax law more with international customs. At the same time, modifications were made to the VAT to bring the application of that tax in line with worldwide practice.²⁶

Foreign Investment

Russia’s first attempt at establishing formal guidelines for foreign investment came with the 1991 Law on Foreign Investment. That law guaranteed foreign investors the same property and investment rights that were available to Russian citizens, with the exception of real property ownership, which was not addressed until the enactment of the Land Code. The law also precluded discriminatory legislation against foreign investment and established protections against nationalization. The 1991 law also established additional benefits and guarantees to foreign investments in certain “free economic zones” such as St. Petersburg.²⁷

The Law on Foreign Investment was updated in 1999. The 1999 law introduced several changes to the prior regime. For example, the 1999 law provides that some foreign investments are entitled to a guarantee of legal stability, thereby protecting (“grandfathering”) eligible investments from changes to the legal structure that increase regulations or costs on investment

activities. The 1999 law also provides guidelines on the establishment of branch offices by a foreign legal entity; establishes a right of foreign investors to receive compensation for damages caused by illegal acts or omissions by government agencies or employees; and clarifies rights for using intentional arbitral tribunals for dispute settlement.²⁸

Enactment of the Land Code

While the Russian legal system has rapidly taken a number of key steps toward reform designed to support a market economy, the right of private ownership of land is one area that has lagged behind. While the Constitution and the Civil Code both recognized the right to own land, those rights were subject to the subsequent enactment of the Land Code. However, despite the fact that President Yeltsin had signed numerous decrees confirming private ownership of land in the early 1990s, the anti-reformers in the Duma blocked passage of the Land Code until 2001. Moreover, much of the responsibility for land regulation was in the hands of regional officials who had complete control over rights to land in their regions.²⁹ These actions not only stunted the pace of foreign investment, but also effectively withheld one of the capitalist system’s greatest sources of wealth—the ability to own land and borrow against it—from the fledgling market economy, and they are symptomatic of the longtime inability of the political parties in Russia to agree on broad reform.

The Land Code recognizes wide-ranging private rights to non-agricultural land. Rights to land consist of ownership, perpetual or indefinite use, free fixed-term lease, lifelong inheritable possession, and easements.³⁰ Importantly, the Land Code includes provisions for foreign ownership of non-agricultural land, effectively ending the legal discrimination against foreign investors’ right to buy and sell land.³¹ Prior to passage of the Land Code, foreign investors only had rights to acquire property complexes, buildings and structures, while the ownership of the underlying land was held by Russian counterparts.³²

As a compromise to facilitate enactment of the 2001 Land Code, agricultural land (representing nearly 98 percent of Russia's land) was carved out of the Land Code and was addressed in a separate law in 2002. That law restricts foreign nationals, foreign legal entities and stateless persons from acquiring rights to agricultural land.³³

Next Steps

In the face of its many challenges, Russia has succeeded in establishing laws that liberalize its economic system and provide basic rights to its citizenry. Through the Civil Code and subsequent legislative enactments, norms of commercial transactions and enterprise organization have also been established. However, at the same time, historical traditions and attitudes continue to influence the evolution of the still nascent legal system in modern Russia. "[T]he Soviet and imperial past have left their marks on the Russian legal system. This legacy affects not only the content of legal institutions and rules, but also underlying attitudes about the nature and significance of law and the way it should be reformed and enforced ... despite massive privatization, the government's role in the economy is much more visible than in other civil law countries. The effects of the traditional Soviet and imperial authoritarian administrative style are felt at every level and branch of government, and are probably reflected in the 1993 Constitution's establishment of a strong executive. Legal nihilism in the mass consciousness continues to undermine efforts to install legality as a principle on which both society and the state should be based."³⁴

Moreover, the fluid state of development of the legal system and an inexperienced judiciary has made it difficult to establish the type of predictability to which Western investors are accustomed. As one executive of a large American company stated in 2000, "I've always considered America to be governed by laws, not men. The reverse may be true in Russia."³⁵ Going forward, it will be important for Russia to establish consistency in both the formulation and application of its laws, thus addressing such concerns and helping to solidify the market-oriented legal framework built over the last 12 years.

Richard Conn is a Washington-based partner at Latham & Watkins, where he specializes in international litigation and Russia-related commercial and political matters. Mr. Conn founded his firm's Moscow office and served as President of the Moscow international bar association. Matt VanderGoot assisted in preparing this article.

Endnotes

¹ Thomas H. Reynolds & Arturo A. Flores, *Foreign Law: Current Sources of Codes and Basic Legislation in Jurisdictions of the World*, Vol. II-B, 2002, II Russia 18.

² The civil legal tradition is distinct from the common law tradition present in Anglo-American legal systems in that a civil law system looks to statutes and other enacted laws for its source of law, whereas a common law system relies on court decisions.

³ Gennady M. Danilenko & William Burnham, *Law and Legal System of the Russian Federation* 3 (Juris Publishing 2000).

⁴ See *id.* at 3.

⁵ *Id.*

⁶ Reynolds & Flores, II Russia at 8.

⁷ Danilenko & Burnham at 245.

⁸ See William E. Butler, *Russian Law* 279 (Oxford University Press 1999).

⁹ Reynolds & Flores, II Russia at 12.

¹⁰ Christopher Osakwe, *Modern Russian Law of Contracts: A Functional Analysis*, 24 Loy. L.A. Int'l & Comp. L.

¹¹ See Butler at 348.

¹² See *id.* at 349.

¹³ See *id.* at 351.

¹⁴ Butler at 412.

¹⁵ See Danilenko & Burnham at 256.

¹⁶ See *id.* at 263.

¹⁷ See, generally, Butler at 425-31.

¹⁸ See, generally, *id.* at 431-34.

¹⁹ See *id.* at 166.

²⁰ See *id.* at 493.

²¹ See *id.*

²² See *id.* at 494.

²³ See *id.*

²⁴ *Id.* at 496-97.

²⁵ See, generally, Alexander Chemlev and Evgeny Astakhov, "Russia: Part Two of the Russian Federation Tax Code," BINIS, August 10, 2000, available at <http://www.bisnis.doc.gov/bisnis/country/000818rstxcde2.htm>

²⁶ See Bruce W. Bean, *Doing Business in Russia: Rebirth of the Russian Nation*, 35 Int'l Law. 961, 982 (2001).

²⁷ See, generally, David M. Black, *So You Want to Invest in Russia? A Legislative Analysis of the Foreign Investment Climate in Russia*, 5 Minn. J. Global Trade 123, 126-28 (1996).

²⁸ See, generally, Mark S. Vecchio and Peter Chessick, "The New Russian Foreign Investment Law: Old Wine in New Bottles?," *Russian Commerce News*, vol. 7, no. 4, July-August 1999, at 7, available at http://www.russianamericanchamber.org/newletter/new_russian_investment_law.html

²⁹ See, Dana Tumenova, *Evolution of Land Reform in Russia: The 2001 Land Code and Its Impact on the Commercial Real Estate Market and Direct Foreign Investment*, 11 Pac. Rim L. & Pol'y J. 769, 792 (2002).

³⁰ See, "Russian Legal Developments: The Land Code," *BISNIS BULLETIN*, December 2001/January 2002, available at <http://www.bisnis.doc.gov.BUSNIS.BULLETIN;jan02bull5.htm>

³¹ See, Tumenova, 11 Pac. Rim L. & Pol'y J. at 791.

³² See, *id.* at 781.

³³ See, "New Land Code Impact," *Russia Business Watch*, vol. 10, no. 3, Fall 2002, at 43.

³⁴ Danilenko & Burnham at 6.

³⁵ Roger D. Billings, *Why Business Fails in Russia*, 35 Int'l Law 123, 123 (2001).

Boston

Riverside Center
275 Grove Street, 4th Floor
Newton, Massachusetts
02466
617-663-5700
617-663-5319 (Fax)

Brussels

Stephanie Square Centre
Ave Louise 65, Box 11
Brussels, 1050 Belgium
+32 (0)2 788 60 00
+32 (0)2 788 60 60 (Fax)

Chicago

Sears Tower
233 South Wacker Drive,
Suite 5800
Chicago, Illinois
60606-6401
312-876-7700
312-993-9767 (Fax)

Frankfurt

Platz der Einheit 2
60327 Frankfurt, Germany
+49-69-60 62 60 00
+49-69-60 62 60 60 (Fax)

Hamburg

Warburgstrasse 50
20354 Hamburg, Germany
+49-40-41 40 30
+49-40-41 40 31 30 (Fax)

Hong Kong

20th Floor, Standard
Chartered Bank Building
4 Des Voeux Road, Central
Hong Kong
+852-2522-7886
+852-2522-7006 (Fax)

London

99 Bishopsgate
London EC2M 3XF
United Kingdom
+44-20-7710-1000
+44-20-7374-4460 (Fax)

Los Angeles

633 West Fifth Street,
Suite 4000
Los Angeles, California
90071-2007
213-485-1234
213-891-8763 (Fax)

Milan

Via San Maurizio, 20
20123 Milan, Italy
+39 02-85454-11
+39 02-85454-140

Moscow

Ulitsa Gasheka, 7
Ducat II, Suite 900
Moscow 123056 Russia
+7-095-785-1234
+7-095-785-1235 (Fax)

New Jersey

One Newark Center,
16th Floor
Newark, New Jersey
07101-3174
973-639-1234
973-639-7298 (Fax)

New York

885 Third Avenue
New York, New York
10022-4802
212-906-1200
212-751-4864 (Fax)

Northern Virginia

Two Freedom Square
11955 Freedom Drive,
Suite 500
Reston, Virginia
20190-5651
703-456-1000
703-456-1001 (Fax)

Orange County

650 Town Center Drive,
20th Floor
Costa Mesa, California
92626-1925
714-540-1235
714-755-8290 (Fax)

Paris

154, rue de l'Université
75007 Paris, France
+33 1 40 62 20 00
+33 1 40 62 20 62 (Fax)

San Diego

701 B Street, Suite 2100
San Diego, California
92101-8197
619-236-1234
619-696-7419 (Fax)

San Francisco

505 Montgomery Street,
Suite 1900
San Francisco, California
94111-2562
415-391-0600
415-395-8095 (Fax)

Silicon Valley

135 Commonwealth Drive
Menlo Park, California
94025-1105
650-328-4600
650-463-2600 (Fax)

Singapore

80 Raffles Place
#14-20 UOB Plaza 2
Singapore 048624
+65-6536-1161
+65-6536-1171 (Fax)

Tokyo

Marunouchi Building
32nd Floor
2-4-1 Marunouchi,
Chiyoda-ku
Tokyo 100-6332, Japan
+81-3-6212-7800
+81-3-6212-7801 (Fax)

Washington, D.C.

555 Eleventh Street, N.W.,
Suite 1000
Washington, D.C.
20004-1304
202-637-2200
202-637-2201 (Fax)