

The Donald W. Treadgold Papers

Number 101
August 1994

*In Russian, East European
and Central Asian Studies*

Law in Russia

Four papers from the legal symposium

***“Changes in the Legal Environment and International
Business in Russia and the Former Republics”***

held at the University of Washington, February 3, 1993.

The Henry M. Jackson
School of International Studies
The University of Washington

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The Donald W. Treadgold Papers welcomes submissions of papers in Russian, East European and Central Asian Studies. All submissions should be sent in triplicate for peer review. Upon acceptance, resubmission on disk is requested. Subscriptions and special orders are available. All correspondences should be directed to the address below.

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Foreward

Publication of *The Donald W. Treadgold Papers in Russian, East European and Central Asian Studies* has been undertaken to provide a forum for the rapid dissemination of current research on the regions indicated by the title. The series will include papers from symposia held at the University of Washington and monographs that may be too long for most journals but too short to appear in book form. The editors welcome submissions of manuscripts (concerning which details are provided on the verso); material submitted will undergo peer review before acceptance for publication.

The series honors Professor Donald W. Treadgold, who retired in 1993 after more than forty years of service to the University of Washington and leadership in the development of Slavic studies in the United States. We expect that the range of materials that will appear in the *Papers* will serve to remind readers of the extraordinary range of Professor Treadgold's own interests. The breadth and depth of the University's various programs in Russian, East European and Central Asian Studies is to a considerable degree the result of his effort.

The donors who contributed to a publication fund in his honor at the time of his retirement are listed at the end. Their contributions have made possible the launching of this series. Particular thanks also goes to Ms. Colleen F. Halley, who is the initial managing editor for the *Treadgold Papers*, and Professor Glennys Young, the REECAS Speakers Series Chair and guest editor for the papers in this number.

Daniel Waugh
Chairman
Russian, East European and
Central Asian Studies Program
The Henry M. Jackson School of International Studies

Law in Russia

Thanks to the generous financial support of the Henry M. Jackson Foundation, the Russian, East European and Central Asian Studies Program of the University of Washington Jackson School of International Studies (REECAS) hosted a symposium, "Changes in the Legal Environment and International Business in Russia and the Former Republics" on February 2, 1993.

The symposium attracted a broad audience that included professionals in the local business and legal communities as well as faculty, students and staff of the University of Washington. In addition to the papers published here, those given by Robert Brumley (Managing Partner, Moscow-Vladivostok offices, Pepper, Hamilton, and Scheetz) and Vladimir Kuznetsov (Progressor Company, Moscow), enriched the symposium.

I should also like to thank Dr. Nicholas R. Lardy (Director, Henry M. Jackson School of International Studies), Carol Vipperman (President, Foundation for Russian-American Economic Cooperation, Seattle), Margaret Niles (attorney, Garvey, Schubert, and Barer), and Dr. Judith Thorton (Economics, University of Washington) for their valuable contributions to the program. Professor Thorton and Adele Barker (now of the University of Arizona) deserve thanks for their enormous help in planning and organizing the symposium.

Special credit is due to Colleen F. Halley, graduate student in the REECAS program, for her help in preparing these papers for publication. Finally, thanks to Dr. Daniel C. Waugh, Chair of the REECAS program, for the many ways in which he supported the symposium and helped make possible the publication of these papers.

Glennys Young
Assistant Professor of History and International Studies
Chair, 1992-93 REECAS Speakers Series

The Russian Legal Tradition

Theodore Taranovski

The role of law and the concept of due process are integral to Western civilization not only because they undergird democratic politics and the notion of human rights. Law is also fundamental to the proper functioning of our economic system based on private property, free enterprise, and commodity exchange. Today, when Russia and the former Soviet republics are striving to overcome the legacy of communism and to become integrated into the Western world economically as well as politically, the question remains of whether the burden of the past, the heritage of what has been called the Russian tradition, places insurmountable obstacles to that goal. A key element of this tradition is the supposed disregard for the rule of law and the absence of intellectual and institutional frameworks within which it could flourish. Accordingly, lack of an appropriate legal environment for the conduct of international business might well loom as a significant obstacle to the normalization of economic and political relations with the successor states of the Soviet Union.

It is commonly assumed both among scholars and laymen that the evolution of tsarist autocracy and its political culture, with overweening state power and subservient society, can be at least partially explained by the fact that Russia did not partake of Western legal heritage, which was based on the principles of Roman and Germanic law as shaped by medieval ideas and practices. That is one of key reasons why Russia failed to develop Western-style democracy and a free society. Absolutism, bureaucratic arbitrariness, a nobility whose lives

and property depended on the tsar's favor, an embryonic middle class, serfdom and the peasant commune with its collectivist mentality, economic backwardness and cultural and religious differences, all separated Russia from the West. Moreover, the October Revolution only intensified these historic trends. The tsars were succeeded by the commissars and autocracy by totalitarianism. Historians, political scientists, and popular writers alike have tended to concentrate on those aspects of the Russian past that underscored the differences with the West because the victory of communism in 1917 seemed to justify them. ¹ Given this traditional interpretation, how likely is it then that post-Soviet Russia will be able to join the world community of nations and the international economy?

The traditional interpretation, however, should be brought into question, particularly in light of what has been happening in the former Soviet Union over the past decade. The problem with the received wisdom is that it minimized the significance of those historical processes that were pointing in the direction of an emergent civil society and constitutional government in the Russian Empire during the nineteenth century. It also minimized what can be characterized as the liberal tradition in Russian political culture. The presence of liberal tendencies in Russia, especially within the *zemstvo* and in the professions, as well as among some prominent statesmen, has long been recognized in scholarship. ² Less noted is that liberalism was integrally linked with the judicial reform of 1864 and with the men who instituted and defended it over the following half century. In fact, the process of social and political modernization of Russia, in which the Great Reforms of the 1860's and early 1870's played a crucial part, produced also a Russian legal tradition that was intrinsically hostile

to the autocracy and that was self-consciously striving to bring the Russian state and society closer to the Western model.

The reform of Russian administration of justice was the most radical, innovative, and technically successful of all the so-called Great Reforms of the reign of Alexander II, and only the emancipation of the serfs may lay claim to matching its historical significance.³ To be sure, the body of the Russian civil and criminal law as such was not reformed. The new system of courts, however, and the codes of civil and criminal procedure that governed their operations marked not only a break with past legal theory and practice but also represented a successful and creative transplantation of the best that contemporary Western jurisprudence, primarily French and English, had to offer. The new administration of justice was independent and separated from administration, with the tsar retaining only the right of pardon. It was staffed by professionally trained judges with tenure for life, who could be dismissed from office only for criminal malfeasance as determined by a court of law. Public trials, oral pleadings, adversary procedure, trial by jury, and the creation of the bar provided important guarantees of due process.⁴ The introduction of a two-tiered system of judicial appeal that permitted appeal in the first instance on the substance of the case (*appeliatsiia*) and after that only on a point of law (*cassation--kassatsiia*) greatly enhanced the significance of the law in Russian life. On a purely technical level, it elevated the function of the law as a formal arbiter of conflict, with its autonomous principles, rules, and procedures that had to be followed, and it enhanced the role of the judiciary in defining the scope and content of this process. To be sure, in line with the general principle of continental

law, the Russian judges were forbidden to interpret the law and were supposed only to apply it and thus enforce the will of the legislator. In practice, the Senate as the supreme court of tsarist Russia, and in particular its Civil and Criminal Cassation Departments, had to clarify the law and began utilizing precedents in the manner reminiscent of common law practice.

Even more important, the very notion of due process had political and normative dimensions, something that was implied by Dicey⁵ and that has increasingly been recognized as immanent in the principle itself. Until then, the law in tsarist Russia was primarily seen as a command, and the political system as well as the political culture of the autocracy was based on the principle of supremacy of legislation and administration. The elements of due process were being insinuated not just into civil and criminal justice but also into operations of government. By the turn of the twentieth century, the First Department of the Senate had emerged as the apex of an embryonic system of administrative justice in Russia, and the idea that societal institutions, such as the zemstvos, or private individuals could seek legal redress against arbitrary action of crown administration was becoming accepted in the political culture of the autocracy. As a result, the judicial reform and its ramifications represented what Marc Szeftel called "germs of constitutionalism"⁶ in the Russian polity and marked a significant step in the direction of the rule of law in the Russian Empire.

To be sure, the new system was only gradually and incompletely introduced into areas outside of the core provinces of European Russia, and the Imperial "borderlands" maintained special legal regimes; military, ecclesiastical, and commercial courts retained independent identity;

political crimes were either handled administratively, which was perfectly legal, or gradually exempted from the jurisdiction of regular courts, especially after 1881; the right of private citizens to sue state officials or institutions was severely circumscribed by very broad interpretation of sovereign immunity and was, in any case, not likely to be very successful in practice; the majority of the Russian people, the peasantry, for all practical purposes remained under the jurisdiction of village customary law and the peasant courts. The peasants were not likely to have much contact with regular administration of justice (except as members of the jury or in suits involving members of other estates). Tsarist reformers such as Nicholas Bunge, the Minister of Finance in the 1880s, bemoaned the lack of a "village statute" that would codify and standardize customary law and in this way help the peasants become cognizant of their legal rights and inculcate the concept of private property.

Indeed, there were serious lapses and lacunae in the body of the Russian law itself. Until the 1830's, the Russian law consisted of the Law Code (*Ulozhenie*) of 1649 and several tens of thousands of acts and edicts enacted since then. Only after Michael Speransky and his assistants compiled the Full Collection of the Russian Laws (*Polnoe sobranie zakonov*) could any real attempt be made to rationalize the law in tsarist Russia. The resulting fifteen volume Code of Laws (*Svod zakonov*), however, was essentially a systematization of the body of operative public and civil law, at least on paper, and by no means a legal reform, the necessity of which was universally recognized. While the code of criminal law (*Ulozhenie o nakazaniiakh ugolovnykh i ispravitel'nykh*) was promulgated in 1845 (and a new version drafted by 1903), Russian civil law, on

which numerous commissions also worked throughout the nineteenth century, remained only partially codified and modernized. Pre-revolutionary scholars often complained about the antiquated and unsystematic character of Russian criminal and especially civil law and of the problems this presented for both legal theory and practice. Thus, even before 1917 Russia lacked a solid legal foundation for the smooth functioning of industrial capitalism. The shortcomings of the Russian law, on which the very concept of private entrepreneurship and the contractual basis of modern economic relations depend, were only aggravated under communism with its command economy, central planning, and abolition of private property. These particular aspects of Russian legal heritage, therefore, are likely to have significant repercussions today and for the foreseeable future.

Nevertheless, when all is said and done there was in pre-revolutionary Russia a legal tradition and a system of courts that could compare to the best that contemporary Western civilization had to offer, at least in matters of what can be termed normal justice. The Russian legal system substantively protected the person of the Imperial subject in civil and, to a lesser extent, criminal cases, and the judicial reform was instrumental in creating and defining the subjective rights of a Russian citizen.⁷ Nor was the notion of individual rights and due process something prominent only in the revolutionary decades of the early twentieth century or reserved for the technicalities of the legal system. The men who drafted the Judicial Statutes of November 20, 1864 were actively involved in conceptualization and implementation of all the Great Reforms of the 1860's and early 1870's. Many of them were graduates of the Imperial School of Jurisprudence, founded in 1835, and of the law

faculties of the Russian universities, and they were joined by other "enlightened bureaucrats," who were interested in improving the effectiveness of the Russian government.⁸

The generation of the young officials that occupied key positions in the St. Petersburg bureaucratic elite during the reform era was moved not only by an exalted notion of the law as the arbiter of human relations and the normative standard for the state but also by currents of romanticism and philosophical idealism characteristic of the 1830's and 1840's in Russia. They were reformers who were willing to work within the system in order to change its very essence and to follow the trail blazed by civilized Europe in the nineteenth century. They desired regularization of autocratic power and curtailment of bureaucratic arbitrariness; they wanted to involve representatives of the Russian society in policy-formulation and prepare them for constitutional government; they were critical of the social hierarchy of estates and supported the equality of citizens under the law; they stood for civil rights, private property, and social initiative rather than state tutelage; they were proud of their professional expertise, and they believed themselves worthy of leading Russia on the road to prosperity and progress. In short, they were nineteenth-century liberals in outlook and temperament, albeit with a statist orientation more characteristic of Central than Western Europe that makes them surprisingly modern in coloration. The perspective of these liberal bureaucrats not only shaped the political culture of a significant proportion of elite St. Petersburg officialdom but was also shared by the professionally educated, middle class elements in the Russian society as a whole.

To be sure, the government soon became

disillusioned with its own handiwork and regretted instituting many of the provisions of the 1864 reform. Conservatives strove to limit the impact of the new courts, and the years 1864 to 1917 witnessed a continuous conflict between the traditional political culture of the tsarist autocracy, exemplified by the policies and outlook of the Ministry of Internal Affairs, and the liberals both within and outside of the government. When the government tried to abandon the policy of partial legislative correctives and to overturn the basic principles of the judicial reform in the 1890's, the legal establishment, supported by Sergei Witte and the powerful Ministry of Finance, succeeded in derailing the effort.⁹ The liberals did not win the war, but they did not lose it either, at least not until 1917. Russia became a constitutional monarchy in 1906. As many have argued, it may have been "sham constitutionalism," but it was also an indication of the direction in which the Imperial polity was evolving. The fact that tsarism was ultimately brought down by war and revolution should not blind us to its inherent potential.

Imperial Russia was, after all, an active participant in the European state system and contemporary capitalist economy, and its culture was an integral part of Western civilization. The pre-revolutionary Russian legal tradition, whatever its defects and no matter how recent and undeveloped, was compatible with the world of Western business and politics. It spoke the same language and was informed ultimately by the same principles. This tradition, however, was largely swept away by the communist revolution of 1917. The political culture of Russian liberalism, whether within or outside of government, as well as of the Russian legal establishment as represented by the universities and the bar was replaced by notions of socialist

legality that had little to do with principles underlying due process and the rule of law as understood in the West. The same was true for the institutional framework and procedural guarantees of the tsarist legal system.

This pre-revolutionary legal tradition has been well nigh forgotten in contemporary Russia. Neither practicing jurists nor legal scholars are familiar with it, at least not at the level of technical expertise and theoretical understanding necessary for its rediscovery and revival. Post-communist Russia clearly lacks historical continuity of legal culture, of institutional and jurisprudential tradition that has been characteristic of most Western societies. Thus, looking to the prerevolutionary past for guidance, except in most general terms, for example, the recent efforts to reintroduce trial by jury, is neither very likely nor likely to produce substantive results. An attempt to reinstitute the prerevolutionary statutory norms and legal practices would be problematic for the simple reason that they are unlikely to meet the needs of the late twentieth century and to reflect social and economic realities of post-communist Russia.

It is much more probable that contemporary legal reformers will look to the West, especially the United States, for theoretical inspiration and practical advice, and there is some evidence that this has been taking place. In itself, this is a commendable effort, and it is reminiscent of what happened in 1864. Nevertheless, the magnitude and complexity of a thorough going legal reform that would of necessity have to involve statutory norms as well as institutions and procedures does not bode well for the success of wholesale borrowing, and, in fact, was not attempted in 1864. The tsarist reform's success was largely due to bold adoption of new legal

principles and procedures that were grafted to the existing body of the Russian law. The existing body of the contemporary Russian law, however, largely inherited from the Soviet past, requires fundamental overhaul, probably more so than the tsarist law did.

These problems, however, should not be seen as insurmountable. The story of the Russian legal tradition as outlined above offers grounds for hope in that it represents a historical precedent. It bears witness to the possibility of fundamental and successful reform, legal as well as political. It offers promise that the new Russia might return to the tsarist pattern of growing affiliation and congruity with the West and produce a state and society based on the principle of the rule of law and respect for the rights of the individual. The dream of a more open and just society inspired many pre-revolutionary liberals, and this is a dream shared by many of the democrats who stood in opposition to communist dictatorship.

Notes

¹ See, for example, among others, Arnold J. Toynbee, Civilization on Trial (New York, 1948), 164-193; Donald W. Treadgold, The West in Russia and China, Russia 1472-1917 (Cambridge, 1973); Robert G. Wesson, The Russian Dilemma: A Political and Geopolitical View (New Brunswick, 1974); Tibor Szamuely, The Russian Tradition (London, 1974).

² See George Fischer, Russian Liberalism (Cambridge, 1958) and V. Leontovitsch, Geschichte des Liberalismus in Russland (Frankfurt am Main, 1957).

³ The significance of the judicial reform and the Russian legal tradition for the political culture of tsarist Russia is more fully analyzed in T. Taranovski, "Sudebnaia

reforma i razvitie politicheskoi kul'tury tsarskoi Rossii," in L. Zakharova, B. Eklof, and J. Bushnell, eds., Velikie reformy v Rossii 1856-1874 (Moscow, 1992), 301-17.

⁴ Samuel Kucherov, Courts, Lawyers, and Trials under the Last Three Tsars (New York, 1953).

⁵ See A.V. Dicey, Introduction of the Study of the Law of the Constitution. 10th ed. (London, 1959), 183-205.

⁶ M. Szeftel, "The Form of Government of the Russian Empire prior to the Constitutional Reforms of 1905-06," in J.S. Curtiss, ed., Essays in Russian and Soviet History (Leiden, 1963).

⁷ See M. Szeftel, "Personal Inviolability in the Legislation of the Russian Absolute Monarchy," American Slavic and East European Review, 17: 1 (1958), 1-24.

⁸ See R. Wortman, The Development of a Russian Legal Consciousness (Chicago, 1976) and W. Bruce Lincoln, In the Vanguard of Reform. Russia's Enlightened Bureaucrats, 1825-1861 (De Kalb, 1982) and his The Great Reforms (DeKalb, 1990).

⁹ See T. Taranovski, "The Aborted Counter-Reform: Murav'ev Commission and the Judicial Statutes of 1864," Jahrbuecher fuer Geschichte Osteuropas 29 (1981), H. 2, 161-184.

Overcoming Legal Obstacles to Doing Business in Russia

Peter B. Maggs

I. Introduction

A few months ago in Moscow a Russian businessman suggested we celebrate his purchase through official channels of \$50,000 dollars at a highly favorable exchange rate of 423 rubles to the dollar. Since he was not a drinking man, we went to McDonald's, and he went up to the counter and got a couple of milkshakes with which we toasted his success. A lot of things have changed in Russia. And it's not just that some people have quit drinking vodka. First, private business is flourishing. Second, foreign investment and foreign trade are going forward. Third, Russians are no longer afraid that the KGB will get them if they associate with foreigners. Fourth, most prices have been allowed to float at market levels, which means that it is possible to buy everything from milkshakes to dollars without waiting in lines. Fifth, hyperinflation is threatening, which is why my friend was delighted to turn his rubles into dollars at a good rate.

II. Making Business Legal

The first step toward a market economy in Russia was making private business legal. This started under Gorbachev, who allowed private businesses to open in many areas of the economy. For a while these businesses were regarded with suspicion and the laws making private enterprise a crime still remained on the books, though largely unenforced. However, by 1991, these laws were

repealed and private business became completely legal. About the only private business now illegal is that of changing rubles to dollars and dollars to rubles. But this law too is unenforced--money changers boldly advertise on every street corner; newspaper advertisements ask for payment in dollars.

III. Providing the Legal Environment for Business

In a remarkably short time, Russia has created many of the basic institutions of business law. It now allows creation of a wide variety of business forms: sole proprietorships, partnerships, and corporations. It has passed laws on security interests and bankruptcy. It has modernized most of its intellectual property legislation. It has created a commercial court system. It has some legislation to encourage and regulate markets.

Russian law already provides those wanting to found businesses with a variety of standard, legally defined, easily available business forms. A law on entrepreneurship provides for creation, with minimal registration formalities, of sole proprietorships and partnerships. A corporation law allows the formation of both closely-held corporations and corporations with publicly-tradeable stock. Initially, rather high minimum capital requirements created some barriers to the formation of corporations; however, inflation has eroded these requirements to virtually nothing. New legislation on entrepreneurship, a new corporation law, and a new civil code are expected by the end of 1993. These will make no radical changes, but will grant somewhat more flexibility in creating corporate structures and somewhat more certainty as to relations between businesses.

The past year has also seen the adoption of legislation on security interests and bankruptcy.

Together, they eventually should provide the basis for the development of a sounder system of financing and a means for providing a decent burial to some of the inefficient enterprises created by state planning. However, for various reasons, which I will discuss in a moment, these laws have not yet had any real effect.

Intellectual property has been an important area, not so much for the Soviet domestic economy as for its international relations. In particular the United States, a major exporter of intellectual property, demanded intellectual property reform as a condition for normalizing trade relations with Russia. Russia now has almost completed the process of modernizing its legislation; it remains to be seen if it will be able to provide effective enforcement mechanisms against trademark counterfeiters and video and software pirates. In October 1992, Russia adopted four new intellectual property laws: the Patent Law of the Russian Federation, the Law of the Russian Federation on Trademarks, Service Marks, and Designations of Place of Origin of Goods, the Law of the Russian Federation on The Legal Protection of Computer Programs and Data Bases, and the Law of the Russian Federation on the Legal Protection of the Topology of Integrated Micro-Circuits. This package of laws brought key areas of Russian intellectual property protection into line with international standards. The trademark law, the software/database law, and the micro-circuit topology law are complete and highly satisfactory. The patent law leaves some important matters of patent administration and employer-employee rights to future legislation. A new copyright law, compatible with international practice, went into effect in August 1993. This law will allow Russia to join the Berne Convention, the leading international

copyright treaty. Serious problems remain, however, in the enforcement of intellectual property legislation.

Commercial legislation is of limited use unless there is also a strong judicial system. Russia has converted the system of economic tribunals which heard disputes arising under the old state planning system into a new system of commercial courts with jurisdiction over all business disputes. There is one important exception; cases involving foreign businesses or Russian businesses with over 30% foreign investment go to the regular Russian courts unless the foreign party consents to the jurisdiction of the commercial courts.

Many foreign businesses prefer arbitration of disputes. The old Soviet institutional court of arbitration has been reborn under the auspices of the Russian Chamber of Commerce. Most Russian businesses are happy to sign an arbitration clause calling for arbitration before this tribunal. Arbitration abroad is also possible, if the parties wish. It has the advantage of providing for arbitration on neutral territory, but the disadvantage for the Russian party of being far more costly. Incidentally, I just accepted appointment as an arbitrator on a case to be heard in London, involving two companies from different parts of the former Soviet Union.

Basic legislation on encouraging and regulating the market economy has been passed but is not fully in effect. There is an anti-trust law and a commission to enforce it. There are the beginnings of stock and commodity exchanges and of regulatory authorities to protect the public in dealing with them. However, enforcement of this legislation is still at a very initial stage. Most small enterprises and many larger ones have been privatized. The result has been the rapid development of vigorous

competition. The huge size of the remaining state enterprises has been more of a handicap than a help to them in the marketplace.

IV. Remaining Obstacles to Business

Despite these accomplishments, very much remains to be done. Export controls on the Russian side complicate deals involving natural resources. Export controls on the American side complicate deals involving high and even not-so-high technology. In Russia, land ownership is restricted and land title records are poor. The tax collection system is inefficient. There is an unhappy combination of high tax rates that discourage business and huge budget deficits that are causing hyperinflation. But the worst problems are in the functioning, or rather the non-functioning, of the money and banking systems.

Russia seeks to control and tax exports of basic raw materials. Constantly changing regulations and bureaucratic infighting in enforcing these export regulations cause numerous headaches for foreign investors. The United States and its allies in COCOM still apply cold war type export controls. Many types of desktop computers that you can buy at your local Radio Shack store cannot be exported without going through an immense amount of paperwork and long delays.

With few exceptions, private ownership of land is forbidden for Russians as well as foreigners. There are various substitutes for private ownership, but none is wholly satisfactory from a legal or business point of view. In urban areas, it is possible to buy apartments, and even whole buildings. However, the land under the building belongs to the city, which may arbitrarily raise land rent charges. In rural areas, it may be possible to make lease arrangements with state or collective farms, or to

negotiate concession agreements to natural resources under a new law on concessions that appears to be making its way through Parliament. The issue of private land ownership is one of the most debated issues surrounding the debate on adoption of a new Russian Constitution. The best case scenario is that new elections will replace the Communist-era parliament and ratify a new Constitution resolving the land ownership question sometime before the end of 1993.

Even if one can find a way around the restrictions on land ownership, the lack of good land title records creates an additional obstacle. Russian legislation has called for the creation of land title registers, but implementing this legislation is no simple task. As an advisor to lawyers working with American businesses investing in Moscow, I have encountered numerous cases of the Russian version of buying the Brooklyn Bridge. Even if urban building records show a particular organization as the lawful occupant of a particular building, that by no means shows that the organization is authorized to sell the building. Often the building was granted to the organization only for a limited purpose, without the right of further transfer. The massive reorganizations that have taken place in recent years often make it difficult to determine the successor of a grantee organization.

Tax rates on both corporate and personal income are high. Many Russian companies use a wide variety of schemes to evade taxes. American businesses are naturally uncomfortable with such schemes. The Russian government has made some concessions to American sensibilities on these matters by providing for favorable treatment in the newly negotiated United States - Russia tax treaty. A thorough knowledge of the treaty and of Russian tax laws may make it possible to structure

transactions so as to minimize unfavorable tax consequences. New legislation on concession agreements may make possible long-term agreements setting reasonable tax levels.

The monetary and banking systems are a disaster. There is no way in Russia to deposit rubles and to receive interest anywhere near the inflation rate. Banks have been offering 60% to 90% interest per year. But inflation has been running 20% or more per month, which is 800% a year. Even worse, once you put money in a Russian bank, you cannot take it out as cash. Like the prince that the wicked magician turned into a toad, money put into a bank turns into something called "accounting rubles." Accounting rubles cannot be turned back into cash rubles, unless one has a fairy godmother or is willing to pay a 15% fee to a sleazy money manipulator. Most banking transactions involve long delays, during which time the rubles involved depreciate substantially in value.

The foreign exchange situation is also a mess. Russian companies are supposed to change half of their foreign currency receipts to rubles through the Russian banking system; they can voluntarily change up to 100% of their foreign currency to rubles. Companies seeking to import foreign goods can bid for these hard currency funds. However, the system does not work. To evade currency controls and taxes as well as to keep their assets in hard currency rather than in hyperinflating rubles, most Russian companies find ways to park their hard currency earnings in foreign bank accounts. So far the Russian government has been unable to secure compliance with its regulations. It is now reported to be offering an amnesty for repatriation of the billions of dollars of hard currency funds held abroad, coupled with a threat of civil and criminal sanctions against those who fail to repatriate their

money. It is unlikely that this campaign will have any more effect than numerous previous campaigns. The government has had some success in recreating something like the old Soviet oil export monopoly and using this monopoly to channel hard currency earnings from abroad. The result for foreign businesses is that the Russian partner will generally pay from foreign bank accounts and ask that payment be made into foreign bank accounts. As far as United States law is concerned, such transactions are completely legal, as long as the American business pays its income taxes. It is legal for a Russian business to have foreign bank accounts if it has the permission of the Russian Central Bank. Most foreign businessmen do not inquire as to whether or not their Russian partner has this permission, preferring a "don't ask -- don't tell" approach.

Nothing is easier than making a wire transfer to a Swiss bank. But dealing with Russian companies that do not have foreign bank accounts is more complex. If they are buying from an American business, they may be able to buy hard currency in one of the twice-weekly auctions and then transfer it--a fairly simple process, except that it can take two weeks to transfer rubles from the provinces to Moscow, during which time they may lose half their value. Making payments to such companies is more complex. Few of them want to receive money by bank transfer to a Russian bank, since it will take them weeks to get at the money and they will have little left after compulsory hard currency sales and high income taxes. The rubles they are forced to buy will lose their value within weeks due to inflation. Banks pay depositors interest rates that are only a tiny fraction of the inflation rate. Few Americans will want to comply with their request to deliver thousands of dollars in cash in person in Moscow or

some provincial city. In Ukraine, the situation has been even worse, because even enterprises that wanted to get money legally have had great difficulty doing so, due to deep problems in the currency and banking system.

The legal culture is difficult and upsetting for an American business executive in a number of ways. We are used to large scale financial manipulation of governments by giving millions of dollars to political action committees. However, Americans are uncomfortable culturally and because of the Foreign Corrupt Practices Act with such practices as giving envelopes of hundred-dollar bills to government officials to get approval for routine transactions. Yet such customs, unfortunately, are widespread in Russia. What most Americans do is to insulate themselves by dealing with a Russian partner, who in turn may deal with another Russian company that deals directly with the government officials involved.

V. Conclusions

Russia has made remarkable progress in the last few years in modernizing its system of business law. It has done the easy task--that of passing legislation based upon the best international practice in such areas as corporation law and intellectual property law. If the political will emerges, it could easily modify its law to provide for private land ownership. Improvement of the monetary, banking, and taxation systems, on the other hand, will require major economic reforms that will create losers as well as winners and so will be hard to achieve. The long tradition of petty corruption also will not vanish overnight.

Despite these problems I am optimistic about Russia. It is the largest country in the world, with the most natural resources, and the biggest pool of

scientists and engineers. The same latent strength that let Russia beat Napoleon and Hitler will let it overcome its present economic difficulties. Indeed, I think these difficulties are highly exaggerated in the American press. American television showed the huge lines in stores before price controls were removed -- it does not show stores and markets today full of food and with no lines. News stories say that Russia's gross national product has fallen by 20% in the past year and a half. However, much of the fall has been in unneeded products, like battle tanks and 100-volume editions of censored selections from Lenin's writings. There has been a huge increase in private business in the service industries that is not in the economic statistics, because of the cleverness of these new entrepreneurs in evading tax and reporting requirements. Personally, I am being driven crazy by what is happening with my own small export-import company, which in its trade with Russia had a gross turnover of a few thousand dollars in 1991, of a few tens of thousands of dollars in 1992, and is now doing business at the rate of a million dollars a year, leaving me drowning in paperwork.

Prospects for Legal Development in Post-Soviet Russia: Reflections on a Case Study

By Kathryn Hendley

The development or evolution of a reliable and coordinated legal system represents a threshold issue for those of us interested in the interrelationship between law and the economy in Russia. After all, it is difficult -- if not impossible -- to structure a transaction if the parties are not relatively committed to obeying rules that are well-known to both in advance. When that is not the case, neither side can be sure of the rules of the game and whether they are operating on a level playing field. These sorts of questions become even more difficult when one of the parties to the deal is a foreigner and, as a result, the parties base their behavior on very different cultural assumptions.

The role of law in the Soviet Union¹ was blatantly instrumental. Law was regarded as a coercive instrument to be used by the state and by the political elite.² Society was acted upon and, consequently, was generally uninvolved in the process of creating law. Society was simply to obey unquestioningly the law that was generated in this top-down fashion. In the public realm, in terms of maintaining social order, law seemed to work pretty well.

But the situation was more mixed in the realm of private law. Here again, particularly in the economic arena, law was very much an instrument of the regime. While fairly stable statutory law existed on a variety of topics, it was subject to alteration by administrative regulations issued by

the ministries. These were the so-called sub-legal acts or *podzakonnnye akty*.³ Within the context of the administrative command system that prevailed during the Soviet period, this arrangement could be expected and, indeed, was arguably even rational. From the point of view of an enterprise manager, predictability stemmed not from the autonomous force of law, but from the knowledge that the superordinate industrial ministry could (and would) exert its influence on behalf of the enterprise. Plan fulfillment, not profitability, represented the key to success under this system. History demonstrates that the economic plan was subject to its own rhythms and dynamics that were often far removed from the dictates of the law.

But it is a new ball game now. The instrumental approach to law that sufficed during the Soviet period is generally found wanting in the new Russia. The introduction of market forces and, perhaps more importantly, the collapse or unraveling of the administrative-command system, have given rise to demands for law to serve as a societal touchstone. The idea that the economy should be controlled administratively has been rejected in favor of what is often referred to as economic levers.⁴ This should not be interpreted as a call for a free market run amok. There is a general recognition that a truly free market exists only in theory and that modern economies, particularly economies that operate on the scale of Russia, are necessarily highly regulated.⁵ But the point is that these regulations now need to be abstract rules designed to apply universalistically, rather than the particularistic regulations (which often were not even published) that were characteristic of the Soviet period.

In a sense, law has to cease being simply a tool of the regime and has to be transformed into an

instrument available to all economic actors. What is needed is flexibility without malleability. In other words, law has to be sufficiently supple so it can be used by economic actors in a wide variety of settings to help them achieve legitimate ends. At the same time, however, there has to be an inner core of reliability, sufficient to allow law to be used as a shield to protect individuals and entities from arbitrary actions by the state and others. In addition to reliability, ordinary citizens must grow to trust the law. After all, it does not matter so much how good a law appears to be on the surface if it lies dormant, *i.e.*, if no one mobilizes it to protect their interests.⁶

The keys here are trust and reliability. But these are concepts that are both relative and complicated. If we unpack them to get at what conditions are necessary for their emergence in the Russian context, three factors come to the fore. Indeed, I have alluded to them previously, but a few words of clarification are in order.

First is the manner in which law is conceptualized. As Lon Fuller has argued, in the Western industrialized democracies, law (at least in principle) is seen as an evolving body of rules, principles and procedures, which both state and society participate in working out.⁷ The reciprocal nature of this process gives rise to a willingness on the part of average citizens to obey and to use the law.⁸ By this, I do not mean to overly idealize Western law. There is no doubt that critical legal scholars have opened our eyes as to many of the shortcomings of Western legal systems. My point is rather that when people are harmed, the pursuit of a legal remedy is considered, *i.e.*, that average citizens regard law as something that can protect them from illegal or arbitrary action by others.

This was not the case in the Soviet Union.

There, the view of law was highly positivistic and instrumental. It was seen as a one-way projection of authority from the state. My review of Moscow trial court records for the 1980's indicates that people tended to resort to legal institutions only when they had no alternative, as in divorce cases or housing disputes.⁹

The second condition that should be highlighted is the substantive legitimacy of the law. What I mean by this is a general societal consensus that the substance of the law is fair.¹⁰ Obviously, this is difficult to judge, particularly for outsiders. The essence is an inquiry into whether the law is responsive to, and reflective of, the standards that prevail in the community at large. The image is of law as an interactive enterprise, rather than as being imposed from above.

A third factor in building a new role for law in society is procedural regularity. This is an intentionally broad and general term and is intended to encompass such criteria as the independence of the judiciary, the accountability of officialdom and the stability, feasibility, availability and clarity of law.¹¹ This bundle of concepts is often referred to as the "rule of law," but I self-consciously avoid that phrase because it is seen to mean different things in different societies and it is often weighted down by considerable ideological baggage. The lack of procedural regularity during the Soviet period is well-known, even to those only casually acquainted with Soviet history. The institutional independence of the judiciary was compromised by the fact that selection and promotion were controlled by the Communist Party.¹² This left judges open to being pressured on an individual basis by Party officials and created a culture of dependency within the judiciary that has outlived the Soviet Union. Procedural regularity was also undermined by the

shortcomings of the law itself. All too often laws were vague and overbroad. They demanded the impossible. Examples of this would include the legislation from the early Soviet period on collectivization and the effort to eradicate indigenous culture by color of law.

Having identified in a static sense what we need to create trust in the law, namely an interactive concept of law, and significant levels of procedural regularity and substantive legitimacy, we now need to think about how to imbue law and the legal system with these qualities. In essence, what is needed is a fundamental change in the way people think about law. This is a very difficult problem and one that is hardly unique to Russia. It calls for an evolutionary model of legal development. Of course, such models exist. Good examples can be found in the work of Max Weber¹³ and Roberto Unger¹⁴. But their usefulness in the post-Soviet context is not immediately apparent since they posit necessary conditions that do not currently exist in Russia and seem unlikely to develop in the near future. At the same time, they need not be rejected out of hand. There may well be pieces of these theories that are helpful in the contemporary Russian context.

My argument has its roots in Weber's theory of the rationalization of law, but is perhaps equally attributable to common sense. The argument is that law will come to matter in society when society demands it and that the emergence of market forces will play a critical role in stimulating this demand. Let me explain through the example of contract law. In the past, contracts between enterprises existed but breaches were more often remedied through administrative means, *e.g.*, by resorting to the industrial ministries, than by pursuing legal recourse through the economic courts (*arbitrazh*).

For the most part, this is no longer an option, since the power of the ministries has been broken. Consequently, it is reasonable to hypothesize that managers might now want the terms of the contract to become enforceable. They might demand universalistic laws that can resolve disputes in a relatively even-handed manner and that will be enforced by an apolitical judiciary. Of course, the flip side of the equation is supply. The state has to provide laws that meet the needs of society and this brings us back to the issues of fairness and the manner in which law is conceptualized.

Do these theoretical observations have any relation to reality? While the situation in Russia remains too transitional to speak definitively about the course of legal development, rays of hope can be spotted. This can be illustrated through a case study of a factory in Russia with which I have worked for the past year. The experiences of this enterprise illustrate well the tensions that are part of the transition and provide us with a fascinating example of how one group of managers is coping with the shortcomings of the existing legal system.

The case study is of the Saratov Aviation Plant.¹⁵ Saratov is an industrial town in the south of Russia on the Volga River that was, until recently, closed to Western visitors due to the high concentration of military industry. During the Soviet period, this factory was part of the military-industrial complex and manufactured missiles and other items pursuant to orders from the government. Over the past five years, however, it has gradually weaned itself away from defense contracts. By 1992, only six percent of its production capacity was devoted to military-related production. Its main product now is a passenger aircraft, the Yak 42, and there are plans to produce a second type of plane. As was typical in the Soviet Union, the enterprise is

diversified beyond aircraft production. There is also a division that produces consumer goods and the enterprise owns several collective farms.

The nature of the plant's production profile has been fortuitous in the current economic climate in Russia. The planes can and are being sold abroad for hard currency. At this point key customers are China and countries in the Mid-East. Consumer goods, such as pots and pans and bicycles, are in relatively short supply in Russia and so can be sold for ruble profits, but can also be bartered for supplies. This proved to be really critical during 1991 and 1992 when money lost much of its value and most trade was conducted via barter. This may be the case once again, given the reports of inflation rates that verge on hyper-inflation. By the same token, the agricultural holdings were also beneficial. They allowed management to provide foodstuffs to workers at a reduced cost and were also helpful in facilitating barter arrangements.

This is not to say that this enterprise has somehow emerged from the turmoil of the past few years unscathed. It is plagued by the same problems as all of Russian industry, *e.g.*, how to recreate old supply networks, how to find the money for needed capital investment and how to position itself, both in terms of production profile and form of corporate organization, in order to become profitable in the years to come. My emphasis is on this latter set of issues -- the property question -- because it poses the more intriguing legal questions.

During the Soviet period, the Saratov plant was organized as a traditional state enterprise. During the Gorbachev years, however, it saw the handwriting on the wall and wanted to change its form. The goal was somehow to liberate itself from the state. During 1990, the managers entered into negotiations with the state and, in January 1991,

they reached an agreement with the Gorbachev government to buy all of the assets of the company on behalf of the collective for 250 million rubles. This agreement was memorialized in a decree of the USSR Council of Ministers.

From a business standpoint, this was a terrific deal for the Saratov plant. The price did not reflect the fair market value of the assets, but rather a depreciated book value. The enterprise paid 135 million rubles immediately and signed a note for the remaining 115 million rubles, but the note was interest-free and was not indexed to inflation. So, by repaying the note in 1992, the enterprise got an even better deal because the rubles they used to repay were worth considerably less than the 1991 rubles. The deal also outlasted the Soviet Union. There had been some fear that the Yeltsin government would demand to renegotiate the deal and require the Saratov plant to pay something that more closely approximated fair market value, but the Yeltsin people signed on to the Gorbachev deal.

The purchase of the assets is also noteworthy from a legal point of view. Basically, the entire transaction was extra-legal. By that, I mean that there was no provision within existing law that provided for what Saratov had done. Keep in mind the timing here. Saratov finalized its deal with the Soviet government in January 1991, and the first Soviet privatization law was not passed until July of 1991. So what we see is that the Saratov managers did not wait for the legal regime to be established, but took matters into their own hands and created their own path.

As a result of having purchased the assets, the property of the Saratov plant was transformed from state property into collective property and, in organizational terms, from a state enterprise into a collective enterprise.

What did it mean to be a collective enterprise? The short answer is that no one really knew. This form of ownership was introduced in the Soviet property law, passed in the summer of 1990, as a kind of political compromise between state property and private property. The law said virtually nothing about what it meant to be a collective enterprise or about what the structure should be or about what sorts of rights and duties attached to ownership. So, having bought their freedom from the state, the managers were left in something of a quandary as to what they should do next.

In short, the law was sufficiently vague that anything was possible. One option would have been to divide ownership among the top managers, *i.e.*, for those who had pushed through the privatization to reward themselves by taking control of the enterprise. In fact, the Western literature on spontaneous privatization would predict just this sort of opportunistic behavior on the part of managers. But the Saratov managers did not do that. Instead, they distributed ownership interests among the work force in general. They created a kind of equity interest that I refer to as a "membership unit" and gave these to the workers on the basis of a formula that took into account seniority, salary and skill level. This behavior by management was not motivated by feelings of altruism, but by a desire to increase labor productivity and a strong belief that the best way to do that was by giving workers a stake in the company. They are convinced that the workers will put in that extra effort if they can see that it will benefit them directly. Whether their belief in the link between productivity and employee ownership will be borne out in practice remains to be seen. Certainly, this proposition has been much debated

by Western economists and at this point it seems to be that the weight of authority goes against it, *i.e.*, that most economists argue that worker involvement in management tends to decrease efficiency.

More interesting from our perspective is the fact that once again we have a situation in which the statutory law failed to provide the necessary framework, requiring the managers to fend for themselves. In essence, they were creating rules to meet their needs.

But this was not an easy process and the results were not entirely satisfying either to the managers or the workers. While there was general agreement on the basic form of employee ownership, there was considerable disagreement and confusion about the underlying details. No one really understood the ownership structure -- what the rights of the worker-owners were -- and the organizational documents were not much help. While the articles of incorporation and the bylaws contained fairly rigorous protection of management rights, they were mostly silent on the question of unit-holder's rights. The language of the bylaws provided merely that unit-holders had the right "to participate in the management of the enterprise." But just what this meant was never clarified. It was not clear when the consent of the unit-holders was needed. Likewise the sort of profit participation to which they were entitled to was not clear. Not surprisingly, the workers reacted somewhat apathetically to the collective enterprise; they failed to see how it changed anything for them. Following the changeover to being a collective enterprise, productivity actually decreased and labor turnover increased. This, of course, had not been the goal of the experiment.

But creating law from the bottom-up is by its

nature a process of trial and error and it stands to reason that experiments do not necessarily work out perfectly the first time. This is particularly true in Russia where the changes are occurring not just at the margins, but at the very core of society. Russian managers are struggling to absorb basic market concepts. But the positive aspect to the bottom-up creation of law is that the message as to what works and what does not goes to the people fashioning policy -- in this case the managers -- in a much more direct fashion than is the case with law generated by legislators in Moscow who are much more removed from the day-to-day operations of the law.

At the same time the Saratov managers and workers were discovering the shortcomings of the collective enterprise form, activity was underway in the country to create more of an infrastructure for privatization and for the operation of non-state companies. During 1991, laws were passed dealing with privatization, joint-stock companies and enterprise operation. Perhaps more importantly, people became increasingly more comfortable with the idea of private property and the concepts basic to the market.

With this as background, the Saratov managers decided to transform their company from a collective enterprise into a joint-stock company. The latter was preferable because it was a statutorily recognizable form. The transformation was also desirable because it gave management a second chance to create an entity that served the ultimate end of stimulating productivity and becoming competitive.

While the commitment to employee ownership remained firm, the consensus quickly broke down when it came to the details. The law did not provide much help. On one hand, the law on joint-stock companies provided clear rules on how

companies were to be formed and what had to be contained in the articles of incorporation. On the other hand, the law was less clear on the mundane details of operation. There were a number of sticky issues. For example, the transferability of the shares was much debated, particularly with regard to workers who quit or were fired. Did they have to give up their shares? If so, what would be the price? Pricing is a difficult problem given the lack of a developed stock market and the fact that all of the stock of this company was to be held by employees, suggesting that trading on an internal market might be more appropriate than opening it to outsiders. Another set of issues revolved around the division of power: which functions would be performed by the board of directors and which would be reserved for the shareholders. There was a very vocal group of managers who wanted the shareholders to decide everything, even such operational details as the purchase of new equipment and the profit split among divisions. This sort of direct democracy might work very well in a closely-held corporation with ten or twenty shareholders, but would seem to be a recipe for chaos in a company with 14,000 shareholders. Another question to be faced was how to build trust among the workers, *i.e.*, how to convince them that stock ownership was something qualitatively different and not just another Moscow-inspired campaign to exhort them to work harder. This brought into question the sort of duties owed to shareholders by directors. In the West, of course, there is a fairly well-developed system based on a fiduciary duty that runs from directors to shareholders. This has its root in the law, but has been greatly expanded in the United States through caselaw. The Russian law, however, was silent on this and many other technical issues, such as what sort of disclosure to shareholders is needed in cases

of corporate transformation and what happens to unit-holders who did not want to be part of the new joint-stock company , i.e., what sort of dissenters' rights exist.

This placed the Saratov managers in the now familiar position of having to create their own rules. This time, however, they were not working entirely in the dark. They were in contact with other Russian enterprises that were making similar transitions and they also sought the advice of Western consultants. Whether what they have come up with will work any better than what they had remains to be seen. At the very least, however, they have made a genuine effort to learn from their mistakes and to build a company that has some potential for long-term viability.

What can we learn from this case study? Certainly it illustrates well the point that law is becoming a more vital part of managers' lives. They look to the law because the old way of doing things -- namely, relying on administrative orders and getting help from industrial ministries -- no longer works. And the fact that they have been so proactive in creating their own rules can be regarded positively. At a very basic level, it indicates a strong demand for law, i.e., for default rules by which economic organizations will be governed. On the negative side, it also indicates that the state is failing to meet its obligation to supply laws that meet the needs of economic actors in the transition period. This is not to say that the state's task is easy, coming up with laws that will facilitate the transition from the administrative-command system to some form of market capitalism is extremely difficult. History provides few successful examples upon which Russian government officials can draw. Further complicating matters is the fact that the people drafting the laws lack experience both with

the market and with the institutions of democratic governance.

But the Saratov case would seem to provide grounds for optimism in the long-run. The dynamic of managers taking matters into their own hands to find solutions that meet their needs appears to be a step in the right direction. Furthermore, it seems unlikely that this is something that is unique to Saratov. In all likelihood, it is happening throughout Russia. Indeed, in many ways it harkens back to the dynamic described by Weber of merchants gradually working out contract law and commercial law through trial and error. But the positive scenario leading to a rational legal system is not inevitable, and to Russian managers it probably seems quite far in the future. The short term in Russia may well be extremely painful for these managers as the process of legal development creaks along. The inevitable frustration may well cause the government (with the support of the managerial elite) to resort to some sort of activist state intervention. If so, it will undoubtedly be modeled more on South Korea than on the old Soviet state.

Notes

¹It should be understood that I am not using the terms "Soviet Union" and "Russia" interchangeably, but am being quite deliberate in my choices and am attempting to be accurate from a temporal point of view.

²See Louise I. Shelley, "Soviet Courts as Vehicles for Political Maneuver," Soviet Union 13:2 (1986), 163-86.

³ See Dietrich Andre Loeber, "Statutes of the Agencies of State Administration in the Soviet Union -- An Unexplored Area of Codification," in Codification in the Communist World, eds. Donald D. Barry, F.J.M.

Feldbrugge and Dominik Lasok (Leyden: A.W. Sijhoff, 1975), 221-38.

⁴ See generally Ed A. Hewett, Reforming the Soviet Economy: Equality Versus Efficiency (Washington, D.C.: The Brookings Institution, 1988).

⁵ See Peter L. Berger, The Capitalist Revolution: Fifty Propositions About Prosperity, Equality, and Liberty (New York: Basic Books, 1986), ch. 1.

⁶ See Donald J. Black, "The Mobilization of Law," The Journal of Legal Studies 2:1 (1973), 125-50.

⁷ See generally Lon L. Fuller, The Morality of Law, rev. ed. (New Haven: Yale University Press, 1969).

⁸ See Tom R. Tyler, Why People Obey the Law (New Haven: Yale University Press, 1990).

⁹ See Kathryn Hendley, "Trying to Make Law Matter: Labor Law and Legal Reform in the Soviet Union," (Ph. D. dissertation, University of California, 1993), chs. 3-4.

¹⁰ See generally Edmund N. Cahn, The Sense of Injustice: An Anthrocentric View of Law (New York: New York University Press, 1949); Judith N. Shklar, The Faces of Injustice (New Haven: Yale University Press, 1990).

¹¹ See Fuller, The Morality of Law; Philip Selznick, Law, Society, and Industrial Justice (New York: Russell Sage Foundation, 1969).

¹² See Donald D. Barry, "The Quest for Judicial Independence: Soviet Courts in a *Pravovoe gosudarstvo*," in Toward the Rule of Law in Russia? ed. Donald D. Barry (Armonk, N.Y.: M.E. Sharpe, Inc., 1992), 257-75.

¹³ Max Weber, Max Weber on Law in Economy and Society, ed. Max Rheinstein (Cambridge: Harvard University Press, 1966).

¹⁴ Robert M. Unger, Law in Modern Society: Toward a Criticism of Social Theory (New York: The Free Press, 1976).

¹⁵ For more detail, see Kathryn Hendley, "Legal Development and Privatization in Russia: A Case Study," Soviet Economy 8:2 (1992), 130-57.

Russian Business and Rule of Law: Problems and Prospects and a Few Words of Advice

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My topic today is a broad one, and intentionally so. I was told by the organizers of this conference that the audience would include representatives from the academic community, members of the business community, and more generally, people interested in Russia. Addressing what we lawyers would refer to as commercial law, I will try to provide a conceptual overview, with reference to concrete examples, that will help us understand the current legal situation in Russia, as well as some of the practical issues that face persons who want to do business there.

At its highest level, commercial law is about efficiency. At this level of abstraction we are concerned not with justice, which is one of the goals the law sometimes tries to reach. Commercial law is about getting economic actors, who perceive opportunity to profit from particular activity, to generate wealth. Commercial law should permit economic actors to move quickly, reliably and predictably from one set of economic relationships to another.

I want to draw your special attention to the limited goal of commercial law, as we have abstracted it. In viewing this body of law, we are not judging, as a political scientist might, whether the rules achieve the fairest distribution of rights; we are not joining economists in identifying whether a particular transaction will provide the Pareto optimal distribution of property. We want to see that commercial law in fact allows economic actors

to act efficiently as they see fit, focusing only on their limited goals of exchanging sets of economic relationships.

From that perspective, we might define commercial law, whether domestic or international, as a set of rules that will govern exchanges in goods or services. That is, of course, an oversimplification, but it will serve our purposes today. What we will value in a body of commercial law is raw efficiency (in the economists' sense of low transactions costs). To meet our idea of good commercial law, any particular set of rules will provide economic actors with means of conveniently and reliably identifying and distributing the respective actors' rights, responsibilities and risks.

We might think of rights, responsibilities and risks as the commercial lawyer's 3 R's. Distribution of rights, responsibilities and risks provides the foundation for any commercial undertaking. What constitutes "rule of law" in the commercial world is the adoption of, and adherence to, a transparent set of rules -- rules of the game -- that address and enforce economic actors' distributions of rights, responsibilities and risks.

I would like to illustrate that idea by examining briefly the "rule of law" that governs American commerce. American commercial law will provide a handy, and I think honest, measure by which to determine problems and prospects associated with Russian commercial law. In particular, I will use two basic notions from our everyday commercial law -- fee simple absolute and an Article 9 purchase money security interest -- as a benchmark for analyzing the Russian commercial system. As we do so, remember our theorizing, and the goals we've discussed: economic efficiency and distribution of rights, responsibilities and risks. A strong rule of law and good commercial legal system

should provide clear rules, and minimize economic actors' transaction costs.

The following examples will serve to illustrate this point. Businesses regularly buy, sell or lease real estate. They need some place to carry on their enterprise. Let's say you want to buy a building for your business. The legal documents you receive will refer to your interest in the property you are acquiring, probably to "fee simple absolute." Legal terminology like fee simple absolute might not mean much to many of you, but to any lawyers present, we know exactly what such terminology means. It very succinctly describes the rights you have to the property, against prior owners and against any third parties. Any American-trained lawyer will know the difference between fee simple absolute and, say, an estate for years or an estate in tail.

Each description provides very good shorthand for the rights being transferred. In structuring a real estate transfer we can, through use of accepted legal terminology, identify precisely rights the parties do and do not intend to transfer. Moreover, we have in place legal systems that permit us to determine and confirm other persons' interests in the property at issue. We have developed virtually fail-safe mechanisms that permit us to assure ourselves, through filing, title insurance and other means, of the range of interests we will in fact acquire if a particular contract for acquisition of real property is signed.

The same is true with general commercial law. It is an overstatement, but not too misleading, to say that In the United States we have codified the law that governs commercial practice. The key statute, which is more or less consistent across the United States, is the Uniform Commercial Code or "UCC". Article 2 of the UCC addresses sales of

goods; Article 3 addresses commercial paper (promissory notes, bank checks); Article 9, security interests, etc.

That leads me to my second illustration from American commercial law. Let's say you need to buy a delivery van for your business, but you don't have the cash on hand right now. UCC Article 9, regarding security interests, provides a simple and well-tested mechanism for a seller to grant you purchase credit while at the same time preserving his or her rights to the vehicle if you fail to hold up your end of the bargain. In fact, in buying and selling the delivery van with seller financing, you and the car dealer would have triggered probably hundreds of legal principles, certainly precedent from hundreds of cases, virtually all based on the UCC.

For example, UCC Article 2 would address the actual contract for the sale of the van; Article 3 would determine what the Seller can and cannot do with your written promise to pay money for the van; and Article 9 would set forth the procedures and the legal principles that govern how the Seller's rights to the van are protected against third parties, even a person who buys the van from you without the new buyer knowing that Seller is out there in the background.

Under developed commercial law, there is no need to negotiate or write out all those provisions. They are self-effecting and economic actors are deemed by the law to know and understand them.

To abstract again, we can think of our commercial law as providing various default contracts. The law governing each stage of our transaction with the delivery van, including what terms we must agree upon, whether our agreement has to be in writing, what promises are "implied" by our contract, what "rights" flow to each party, what

"risks" each party assumes, even what "risks" third parties assume if they in turn buy the van from you, or even if they buy from the Seller your promise to pay for the van. All of that is set forth in commercial law, easily accessible to anyone interested, either by looking it up in the local law library, or more readily still, by asking a lawyer.

According to our abstraction of commercial law, that is as it should be. We want commercial law to provide a system by which parties can efficiently establish the basis for an agreement. A developed commercial law permits us to skip most of the details regarding what rights, responsibilities and risks are being transferred and focus quickly on to allocations that would alter default rules. In principle, the better the commercial law, the more reasonable and efficient those default rules are.

Now in that short overview, I've left an awful lot out, not just on the legal side, but regarding other whole institutions or industries that economic actors in the United States take for granted: a reliable currency; a banking system to assure efficient and predictable movement of that capital; an insurance industry to assure reliable coverage of risks we agree to assume; not to be underestimated, a business culture and ethic to assure common expectations; and finally, a developed system of legal enforcement (courts, procedures and civil remedies) to assure contracts mean what they say.

When all is said and done, aside from dollars and identifying what rights the parties intend to transfer, the key to any transaction is risk. If you pay your local car dealer \$10,000 for a delivery van and it breaks down as you leave the lot, are you out \$10,000 or do you have recourse against the seller? What are the seller's rights if the check you wrote bounces? We want a reliable means of knowing the rights, responsibilities and risks transferred by our

contract. You can determine that answer by reading your contract and referring to the UCC.

The same is true in the most complex commercial transaction. Ninety percent of the paperwork generated in a typical asset purchase is, after the deal has been consummated, incredibly boring and routine. The documents the lawyers assemble for a complex transaction might amount to literally hundreds and hundreds of pages. Most of that, however, is really there only so that the promises set out in the few heavily negotiated clauses of the asset purchase agreement will in fact prove binding on the parties.

So much for American commercial law generally. We've looked at efficiency and the three R's. With those measures in mind, let's turn to the very different world of Russian law and Russian business.

We're Americans and we've come to Russia to make money. Time is money, especially in Moscow. We know what money we're willing to invest and the rights, responsibilities and risks we are after. How does the Russian legal regime work to permit us to cut to the chase so we can focus on and allocate what really matters, as efficiently as possible?

We should start by noting the wide variety of transactions Americans might undertake in Russia. You can sell products in Russia; manufacture products in Russia for sale in Russia or abroad; you might establish your own wholly-owned subsidiary, or create some corporate or contractual joint venture; you might harvest and export natural resources. The specific legal analysis will change depending on the nature of the transaction we review.

Let us assume that you want to buy land and construct a plant in Russia. Remember fee simple absolute? We're in Russia now, so forget it. One *can*

buy real property in Russia. More likely you will look to rent it. But how do you determine what rights are subject to transfer, what rights the buyer or lessee will in fact acquire, what will be the outcome if the your contractual expectations are not met? There are no easy answers.

In Russian business and law, absence of clear answers almost *is* the rule. Take the most fundamental of business questions — getting paid for providing goods and services. There is probably more confusion regarding Russian currency regulations than anything else in Russian commercial law. An article in this Monday's *Seattle Post Intelligencer* stated the following: "Because Russian currency, the ruble can't be converted, be exchanged for dollars or other hard currency, entrepreneurs sometimes find innovative ways of receiving payment for merchandise shipped to Russia...." I don't know how many times I've seen this in print. It is wrong. The ruble is not *freely* convertible, but it is convertible. Russians, including Russian businesses, have the right to buy dollars through licensed banks; the right on the part of businesses is restricted expressly to purchasing hard currency for payment to foreign providers of goods or services. In fact, you as a foreigner are forbidden to sell goods into Russia for rubles. You can only sell for hard currency.

Then again, if you for whatever reason, want to sell for rubles, you can arrange to do so. And despite popular confusion, there is no need to use agents or middle men to do so. If you set up a wholly-owned subsidiary, which some of our clients have done, that company can, as a general rule, sell product/services *only* for rubles.

But let's complicate things a bit: Let's say you're willing to sell some goods for rubles but others only for dollars. Do you have to run separate

operations? No, Russian companies are permitted, with special permission (a special license), to sell goods/ services in Russia for hard currency. How do you get that license? The rules are set out in CB (Central Bank) telegram 239-92. But the Central Bank mechanism for granting hard currency licenses is now under review, so temporarily, they are not being issued. Remember our concern with transactions costs?

Rights, responsibilities and risks? Let's imagine we manufacture something in Russia. Demand is high, our workers are skilled, supplies are available. We know that Central Planning is dead. We're ready for business, so we tell our people: go out and bring back some orders.

Well, what do we put on your order forms? Under Russian law, all prior Soviet law is in full force and effect, except to the extent it contradicts more recent Russian laws. Did you have someone review the Soviet law of Obligations (Russian Civil Articles 158-266)? What about the Russian Law on Consumer Protection? Then again, Central Planning may be history, but what do you understand about State purchase orders? Will you be able to we meet your contract requirements to other economic actors?

Obligations? How do you ascertain that your contracts impose enforceable obligations? Are there technical formalities to observe? What if you get them a little bit wrong? Let me quote for an obscure regulation that has been in effect since last spring. It provides that certain, specified persons within an enterprise must sign jointly certain types of contracts and documents. "*Without such signature such documents shall be null and void.*" These rules apply not only to international contracts, but to contracts between Russian entities.

Across the board, a western investor needs to

be careful to secure competent and experienced counsel in dealing with Russia. And not even the best advice will eliminate substantial risk.

The risk of change in substantive law is a case in point. Russia enacted its Law on Corporate Profits Tax in December of 1991 (not to be confused with the "Law on Income Taxation of Enterprises within the RSFSR for 1991", which by its own terms expired December 31, 1992.) The law on Corporate Profits Taxation was not published until March of 1992. In the meantime there was no way of knowing what an enterprise's tax liabilities would be. In March, 1992, the government published both the text of the Corporate Profits Tax Law and an RSFSR Tax Service Instruction regarding calculations and payments pursuant to that law. Then in July of 1992, the Russian government amended that law. Those amendments were first published, anywhere, in September of 1992, and then were made retroactive to January 1, 1992! Effectively, for nine months businesses that operated under officially published versions of the Corporate Profits Tax law were simply operating in the dark.

Assume you have made the tough decision to purchase, import and install different machinery for your plant. The September 1992 publication clarified what constituted deductible reequipment expenses by noting that whether such outlays qualified "shall be regulated by USSR Gosplan, USSR Gosstroi, Stroibank USSR and USSR MinFin (Ministry of Finance) Letters dating from 1984", and certain other documents. These various regulations can prove extremely difficult to obtain.

Americans wishing to do business in Russia face communication difficulties. The Soviet bureaucracy commonly used, and the Russians still use, "telephonegrams" to distribute binding internal decisions or regulations. With a telephonegram, the

secretary to one bureaucrat calls the secretary to another (perhaps in a different ministry or organization), dictates the new rule, jots down such information as the date and time the message was relayed, and the regulation is thereby effectively distributed. I have literally had Russian bureaucrats refer to telephograms that directly affected my clients' interests, but then hesitate to share the content of the relevant telephogram, because it was not clear to the bureaucrat whether the telephogram instruction was confidential.

There are other problems. Inflation itself wreaks havoc on business and tax planning. Inflation is now running at about 50% per month or 1000% per year. The Law on Corporate Profits Taxation penalizes companies that pay their employees more than 4 times the official minimum wage. Official minimum wage moves slowly, and is really more like an estimation of poverty level. Companies must pay more for good workers.

As an aside, it is a myth that Russians will not make good capitalists. Russian entrepreneurs' hunger for and ingenuousness about retaining capital can be awesome. Faced with the rule that payments of salaries equal to more than 4 times the minimum wage will lead to penalties, Russian entrepreneurs quickly rewrote labor contracts. Salaries, it should come as no surprise, totaled only 4 times the monthly minimum wage. But employers started paying their workers rent or fees for use of pens and pencils, the worker's desk, use of the workers' briefcases, etc.

But back to more serious matters, such as criminal law. You cannot walk out of your hotel, even through your hotel lobby, without someone offering to buy your dollars. Everywhere you look on the street, people are trading currencies, selling anything and everything for \$ or DM. Does anyone

here know the law on this? Russian Federation Criminal Code § 88: for violation of hard currency laws and regulations: 3-8 years in prison, with or without confiscation and with or without 2-5 years of exile. For speculation in large sums, 5-15 years in prison, and confiscation, with or without exile. Is it enforced? Some of you are shaking your heads, "no." The head of the Moscow police division responsible for enforcement was quoted in January, 1993 as having 300 criminal actions, including against foreigners, prosecuted in Moscow last year.

Thus, Russian commercial law does not yet provide much in the way of efficiency. Even the most basic information can be difficult to acquire. There are no, or very few, simple ground rules and common means of quickly, simply and reliably identifying and allocating rights, responsibilities and risks. Add to this fact the reality that the notions of Russian business culture, or as one sometimes hears, Russian business ethics, are almost oxymorons. Contracts are often simply ignored. Formal enforcement mechanisms, remedies under the law, are largely illusory. Corruption is rampant.

On the topic of corruption, one of the best publications regarding business in Russia is *Ekonomicheskaja gazeta* ("EG"). Yeltsin issued a decree in April of 1992 that addressed corruption within the government, but I gather it has not attracted much notice outside of Moscow. According to an article published in *EG* Issue No. 43, October, 1992, for the first 9 months of 1992 the Ministry of Interior reported 95,000 economic crimes. On the bright side, this was 10,000 less than for the equivalent period in 1991. Then again, the Ministry explained that the drop was related only to their focus in 1992 on economic crimes that were "more serious, multi-leveled, and better concealed."

It may not mean much to your Russian

counterparts, but you as an American had better be very much aware of the United States Foreign Corrupt Practices Act. In a nutshell, that law, which includes severe criminal penalties, applies to American citizens and companies, doing business anywhere in the world. Clearly, Congress did not have Russian business in mind when they drafted this statute. How serious a problem is it? Let me quote from boilerplate we use in generic contracts with Russian parties. Listen to the variety of forbidden activities:

In providing services to us, you shall undertake only such activities as are lawful under the written laws and regulations of Russia, and shall conduct your activities in compliance with the requirements of the United States Foreign Corrupt Practices Act. To that end you expressly represent and warrant that you will not offer, give, promise to give or authorize any gift, money, or other thing of value to:

- (a) *any person who is an officer or employee of the Russian government or any department, agency or instrumentality thereof, or any person acting in an official capacity for or on behalf of the Russian government or any department, agency or instrumentality thereof, for purposes of influencing acts or decisions of that person or trying to get that person to act or fail to act in violation of his duty or to influence his government;*
- (b) *any political party, party official,*

or candidate for purposes of influencing acts of that party, official, or candidate or trying to get that party or official to act or fail to act in violation of its or his duty or to use its or his influence with the Russian or any other government; or

- (c) *to any other person when given with the knowledge or firm belief that all or a portion of the gift, money or other thing of value will be used for the types of purposes set forth at items (a) and (b) above*

in order to help us or any subsidiary or affiliate of ours to obtain or retain business for or with, or direct business to, any person. Without limiting the foregoing you agree that any public officials who are shareholders of any company with which you are affiliated shall be deemed to come within the proscriptions set forth in this Section.

Despite these obstacles, there is such a thing as Russian business. And it is possible to do business in Russia. The uncertainties and risks should not be underestimated, but with careful planning, close attention to legal and economic developments, and careful attention to risk management, business can proceed.

The real prospects for rule of law are in the government's willingness to listen to foreign businessmen and commercial lawyers. For example, on June 10th of last year the Russian Government at last announced that it would provide grandfather protection to joint ventures that, under Soviet law in effect since 1987, had been entitled to certain tax

holidays. The Russians are working on scores of drafts of new commercial laws, all based, at least in part, on western commercial practice.

Remember UCC Article 9? The Russians do have a law on security interests (*O Zaloge*), effective 6 June 1992. It is not much in use, so far as I am aware, but the basis is being laid for real commercial law. The Russians have a strict consumer protection law that is a double edged sword. It does clarify consumers' rights in purchases of goods, but it is so strictly in favor of consumers that inevitably it will either be ignored or amended. It will take time for the Russian legal system to grant capitalists, who only a few years ago were by definition enemies of the State, the spectrum of rights they take for granted in the United States and other developed economies.

What advice can I offer? If you are an entrepreneur or a small company, you probably want first and most importantly to find a reliable partner in Russia. This, in itself, is no small task. Avail yourself of local resources, including the Foundation for Russian American Economic Cooperation and the newly-opened Russian Consulate General.

Ambassador Lukin, the Russian Federation Ambassador to the US, was here last week to participate in the official opening of the Consulate. Both Ambassador Lukin and Consul General Georgi Vlaskin have made very clear their interest in developing business relations between the United States, and specifically the Pacific Northwest, and Russia.

If you are a medium or large company, make sure you go in with your eyes open. Despite the horror stories, the fact is that Russian law is improving, almost daily. Watch the macroeconomic developments, study your market carefully, and most importantly, get experienced advisors on your team before you take the field.

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