

**LONGMAN** 

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**SPECIAL REPORTS**

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**LEGAL ASPECTS OF  
DOING BUSINESS  
IN RUSSIA**

**A specially commissioned Report**

**W E BUTLER and M E GASHI-BUTLER**

**of**

**CLIFFORD CHANCE**

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# Legal Aspects of Doing Business in Russia

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W E Butler and M E Gashi-Butler *of* Clifford Chance

LONGMAN 

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**Clifford Chance** is a leading international law firm, based in London, with offices in Amsterdam, Brussels, Frankfurt, Hong Kong, Madrid, Moscow, New York, Paris, Singapore, Tokyo, the United Arab Emirates and Warsaw. The practice in the Commonwealth of Independent States is administered from London and Moscow, with extensive contacts throughout the principal cities of the Russian Federation and the Independent States.



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# Table of principal legislation of the Russian Federation

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Accounting	– Statute on Bookkeeping Records and Reports in the Russian Federation /16.02.1992/
Administrative Law	– Code on Administrative Violations of 1984, as amended
Air Transport	—
Atmosphere	—
Banking	– Law on Banks and Banking Activity /02.12.1990/, as amended – Law on the Central Bank (Bank of Russia) /02.12.1990/
Bankruptcy	– Law on Bankruptcy (adopted November 1992)
Citizenship	– Law on Citizenship in the RSFSR /28.11.1992/
Civil Law	– Civil Code of 1964, as amended – Code of Civil Procedure of 1964, as amended
Commodity Exchanges	– Law on the Goods Exchanges and Exchange Trade /20.02.1992/
Companies and Partnerships	– Statute on Joint-Stock Societies /25.12.1990/, as amended
Competition	– Law on Competition and Limitation of Monopolistic Activity in Goods Markets /22.03.1991/ – Decree on State Regulation of the Activities of Monopolistic Enterprises /20.01.1992/ No 2218–1
Concessions	—
Constitution	– Constitution of the RSFSR of 1978, as amended
Consumer Protection	– Law on Consumer Protection /22.05.1991/
Co-operative Societies	– Law on Consumer Co-operatives in the Russian Federation /19.06.1992/
Corporate Taxes	– Law on Profits Taxes of Enterprises and Organisations /27.12.1991/
Criminal Law	– Criminal Code of the RSFSR of 1960, as amended – Code of Criminal Procedure of 1960, as amended
Culture	– Law on the Fundamental Principles of Legislation on Culture /09.10.1992/
Currency	– Law on Currency Regulation and Currency Control /09.10.1992/ – Law on the Russian Monetary System /25.09.1992/
Ecology	– Law on Environmental Protection /19.12.1991/
Ecology Tax	—

*Table of principal legislation of the Russian Federation*

---

Enterprises	– Law on Enterprises and Entrepreneurial Activity /25.12.1990/, as amended
Entrepreneurship	– Law on the Regulation Fee for Natural Persons Engaging in Entrepreneurial Activity and the Procedure for their Registration /07.12.1991/
Excise Duty	– Law on Excises /06.12.1991/, as amended
Farms	– Law on Peasant Economy /22.11.1990/
Foreign Investment	– Law on Foreign Investments in RSFSR /04.07.1991/
Forests	– Forestry Code of 1978, as amended
Free Economic Zones	– Decree on the Creation of Free Economic Zones /14.07.1990/
Free Trade	– Presidential Edict on Free Trade /29.01.1992/
Fuel Tax	—
Highways Tax	– Law on Highway Funds /18.10.1991/
Import/Export	– Decree on Customs Duties for Imported Goods /15.10.1992/No 32 – Presidential Edict on the Export of Strategically Important Raw Materials & Goods /14.01.1992/ No 628
Income Tax of Individuals	– Law on Income Tax of Natural Persons /07.12.1991/, as amended
Insurance	—
Intellectual Property	– Law on Trademarks, Service Marks and Appellation of Places of Origin /23.09.1992/ – Law on Legal Protection of Computer Software and Databases /23.09.1992/ – Law on Legal Protection of Topologies of Integral Micro-Circuits /23.09.1992/ – Law on Patents /23.09.1992/
Internal Water Transport	—
Investment	– Law on Investment Activity in the RSFSR /26.06.1991/
Investment Tax Credit	– Law on the Investment Tax Credit /20.12.1991/
Judicial System	– Law on the Constitutional Court of the RSFSR /1991/ – Law on the Arbitrazh Court /04.07.1991/, as amended – Law on the Status of Judges in the Russian Federation /26.06/1992/ – Law on Court Organisation in the RSFSR /08.07.1981/, as amended
Labour Law	– Labour Code of 1971, as amended – Law on the Increase of the Minimum Wage /21.04.1992/
Land	– Land Code of the RSFSR /25.04.1991/ – Law on Payments for Land /11.10.1991/, as amended
Lease	—
Mass Media	– Law on Mass Media /27.12.1991/ – Decree on Licensing in the Sphere of Communications /22.12.1990/ No 596 – Provisional Statute on Communications /13.07.1992/

*Table of principal legislation of the Russian Federation*

---

Merchant Shipping	—
Motor Vehicle Transport	—
Oil and Gas	—
Ownership	— Law on Ownership in the RSFSR /24.12.1990/, as amended
Pensions and Social Insurance	— Law on State Pensions in the RSFSR /12.11.1990/, as amended — Decree on Medical Insurance of Citizens in the RSFSR /25.01.1992/ No 41
Pledge	— Law on Pledge /29.05.1992/
Privatisation	— Law on Privatisation of State and Municipal Enterprises in the RSFSR /03.09.1991/, as amended — Law on Inscribed Privatisation Accounts and Deposits in the RSFSR /03.07.1991/ — Law on Privatisation of Housing Facilities in the RSFSR /04.07.1991/
Railway Transport	—
Resort Tax and Other Local Taxes and Duties	— Law on the Resort Fee for Natural Persons /12.12.1991/
Securities and Stock Exchange	— Decree on the Use of Promissory Notes and Bills of Exchange in Business Transactions /24.06.1991/ — Decree on the Confirmation of the Statute on the Issuance and Circulation of Securities and on Stock Exchanges in the RSFSR /28.12.1991/ No 78
State Duty	— Law on State Duty /09.12.1991/
Subsoil	— Law on Subsoil /21.02.1992/, as amended — Statute on the Procedure for Licensing the Use of the Subsoil /15.07.1992/
Taxation of Banks	— Law on Taxation of the Revenue of Banks /12.12.1991/
Taxation of Insurance Activities	— Law on the Taxation of Revenues from Insurance Activities /13.12.1991/
Taxation of Securities Transactions	— Law Concerning Taxation of Securities Operations /12.12.1991/
Taxation System	— Law on the Fundamental Principles of the Tax System in the Russian Federation /27.12.1992/, as amended — Law on the State Tax Service of the Russian Federation /21.03.1991/, as amended
Taxes on Successions and Donations	— Law on the Tax from Property Transferred by Way of Inheritance or Gift /12.12.1991/
Tax on Property of Enterprises	— Law on the Tax on the Property of Enterprises /13.12.1991/
Tax on Property of Individuals	— Law on Property Taxes of Natural Persons /09.12.1991/, as amended
Urban Construction	— Law on the Fundamental Principles of Urban Construction in the Russian Federation /14.07.1992/
Value-added Tax	— Law on Value-added Tax /06.12.1991/, as amended
Water Resources	— Water Code of 1972, as amended

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# Contents

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	<i>Page</i>
<i>The authors</i>	v
<i>Table of principal legislation of the Russian Federation</i>	ix
<b>1 Independence of the Russian Federation: what it means for investors</b>	<b>1</b>
1.1 The Russian Federation and the Commonwealth of Independent States	1
1.2 The effect of Russian independence on the legal framework	3
1.3 Prospects for change in the legal framework	5
<b>2 Sources of law in Russia</b>	<b>7</b>
2.1 Hierarchy of legal rules	7
2.2 Status of sources of law	11
<b>3 Structuring relations with a Russian partner: avoiding the common mistakes</b>	<b>13</b>
3.1 Preliminary contracts: is a letter of intent binding?	13
3.2 Juridical status of a Russian partner: does it have the power to contract?	14
3.3 The Russian partner's contribution: does it have the right to transfer its contribution?	14
<b>4 Setting up operations in Russia</b>	<b>17</b>
4.1 Legislation of the former USSR on juridical vehicles: its continuing implications for the unwary foreign investor	17
4.2 Russian legislation on vehicles for investment	18
4.3 Accreditation of representation offices	20
4.4 Choosing the appropriate form of investment	20
4.5 Staffing a Russian presence	22
<b>5 Acquiring ownership in Russia</b>	<b>23</b>
5.1 Concepts of ownership	23
5.2 Pledge	24
5.3 Trust	25
<b>6 Privatisation opportunities for the foreign investor</b>	<b>27</b>
6.1 Privatisation legislation	27
6.2 Engines of privatisation	27
6.3 Participation of foreign investors	28
6.4 Objects of privatisation	29
6.5 Means of privatisation	29
6.6 Opportunities for the investor	30
<b>7 Intellectual property</b>	<b>33</b>
7.1 Law on patents	33
7.2 Law on trademarks, service marks and labelling of origin of product	33
7.3 Law on computer software	34
7.4 Law on integrated circuit topology	34
7.5 Legislation on copyright	34



	<i>Page</i>
<b>8 Taxation in Russia</b>	37
8.1 Law on Fundamental Principles of the Tax System	37
8.2 Law Concerning Tax on Profit	38
8.3 Law on Value-added Tax	39
8.4 Law on Excises	40
8.5 Other taxes: customs	40
<b>9 Banking and currency</b>	41
9.1 Creation of banks	41
9.2 Currency regulation	41
<b>10 Status of the foreign investor</b>	43
10.1 Law on Investment Activity	43
10.2 Law on Foreign Investments	44
<b>11 Natural resources</b>	45
11.1 Land relations	45
11.2 Subsoil relations	46
11.3 Forests, water, the atmosphere and flora and fauna	46
<b>Appendix 1 — Law on Ownership in the RSFSR (1990, as amended)</b>	47
<b>Appendix 2 — Law of the Russian Federation on Pledge (1992)</b>	57
<b>Appendix 3 — Statute on Joint-Stock Societies (1990)</b>	67
<b>Appendix 4 — Law on Privatisation of State and Municipal Enterprises in the Russian Federation (1991, as amended)</b>	77
<b>Appendix 5 — Law on the Fundamental Principles of the Tax System in the Russian Federation (1991, as amended)</b>	93
<b>Appendix 6 — Law on Foreign Investments in the RSFSR (1991)</b>	103
<i>Bibliography</i>	113
<i>Index</i>	115

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# 1 Independence of the Russian Federation: what it means for investors

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## 1.1 The Russian Federation and the Commonwealth of Independent States

### 1.1.1 The origins of modern Russia

The Russian Federation, or Russia — both terms are officially recognised as the legal names of the country and may be used interchangeably — came into being on 26 October 1917 (using the old style calendar), following the overthrow of the Russian Provisional Government in St Petersburg by a coalition of Bolsheviks and Mensheviks. From 1917 until December 1991-January 1992 the country was known as the Russian Soviet Federated Socialist Republic (RSFSR), and this term is still in legitimate legal use for a year or so during the transition to the use of the new terminology. Investors should be aware that the expression ‘Russian’ or any word combination or abbreviation thereof is protected by law in Russia and may be used, for example, in the name of a company or a product only with permission and the payment of a fee.

From the October Revolution in 1917 until 30 December 1922 the RSFSR operated as an independent State, governed by the All-Russian Communist Party (Bolshevik), in close co-operation with three sister States: Belorussia, Ukraine and the Transcaucasian Soviet Federated Socialist Republic (which later broke up into Armenia, Azerbaidzhan, and Georgia).

Within the RSFSR a complicated network of administrative-territorial units under various names emerged as the Russian armed forces gradually consolidated control over the far reaches of the former Russian Empire. The Bolsheviks endeavoured to give effect to two principles simultaneously and thereby avoid what they regarded as one of the fatal mistakes of the Imperial Russian Government. First, given the gigantic size of the country, which extended from the Gulf of Finland in the West to the Pacific Ocean in the East, a complex hierarchy of local government was to be created. Second, wherever the concentrations of ethnic minorities so justified, units of local government were to reflect the rights and aspirations of those minorities for some form of national self-determination. Hence the concept of a Russian ‘federation’ of peoples and nations at various levels of development and national self-awareness.

In the Bolshevik perception, the RSFSR was Russian because the Russian people were by far the largest single ethnic component of the country; it was ‘soviet’ because legislative power was formally vested in ‘soviets’ or ‘councils’ at all levels of the State; it was ‘federated’ because all ethnically-based units had joined together — voluntarily, it was alleged — to create the RSFSR; it was ‘socialist’ because the Bolshevik ideology was committed to achieving a rapid transition to socialism; and it was a ‘republic’ because the Imperial monarchy had been displaced by a new system reflecting Bolshevik understandings of what a republican form of government should be.

Although in a few instances ethnic groups were incorporated into the RSFSR on the basis of treaties, usually after the local leadership had capitulated to the Russian armed forces, most ethnically-based units of government within the RSFSR were simply carved out by the fiat of the central authorities in Moscow. With adjustments from time to time — for example, sometimes the stature of individual peoples or nations within the Federation would be raised or lowered by reorganisations of these

entities, or, as some peoples experienced during the Second World War, entities would be abolished and peoples forcibly removed from their territories on suspicion of collaborating with the Germans — this structure has come down to the present day.

### **1.1.2 The rise and demise of the Soviet Union**

On 30 December 1922 the RSFSR joined with Belorussia, Ukraine and the Transcaucasian Republic to form, on the basis of the so-called Treaty of the Union, the Union of Soviet Socialist Republics (USSR), widely known as the Soviet Union. The formal structure of the Soviet Union was a species of confederation. Four independent States had joined together to create a Union which, on paper at least, was to exercise limited powers ceded to it by the founding members, each of whom reserved the right of secession. The members of the Soviet Union were known as 'union republics', and in the course of time their number expanded to as many as 16 and, when the Soviet Union disappeared in late 1991, were 15 in number.

Although the Soviet Union was designed to be a confederation with limited powers, as its first Constitution of 1924 indicated, powerful factors combined to contribute to the increasing centralisation of the Union: the pervasive role of the Bolshevik Party, later renamed the Communist Party of the Soviet Union; the introduction of national economic planning in the late 1920s and assignment to the Union government of key fiscal, budgetary, planning, administrative, military, foreign policy, foreign trade and other responsibilities; and the growing power of Stalin as the unchallenged leader of the entire complex. The 1922 Treaty of the Union was never altered in any way to reflect these changes. The Union Constitution of 1924 and individual constitutions of the union republics based thereon were replaced in 1936–38, by which time all individual constitutions were virtually identical, and again in 1977–78.

The dissolution of the Soviet Union occurred, legally, in two stages. The first stage saw the secession of the three Baltic republics (Estonia, Latvia and Lithuania) following a prolonged campaign during the years 1988–91. The second stage saw the formal denunciation of the 1922 Treaty of the Union by the three remaining original members (the RSFSR, Belorussia and Ukraine) on 8 December 1991, and their example was followed by the other nine union republics throughout December 1991. These two stages reflected a prolonged period of ferment during which the Union authorities made strenuous efforts to salvage a central Union authority, either by replacing the 1922 Treaty of the Union with a new treaty (which failed when some of the Soviet leadership staged an abortive coup in order to prevent the treaty being signed), or by creating an economic community to replace many Union functions (a treaty to this effect was signed in October 1991 but was never ratified by any of the signatory parties).

### **1.1.3 Post-Soviet structures**

Having dismantled the Soviet Union, the 12 surviving union republics (the three Baltic states having gone their own way) styled themselves the Independent States. They faced, and continue to face, formidable policy choices. The Union had been conceived as a single economic space with a very high degree of legal uniformity and centrally-determined and administered economic policies, and the union republics had become economically interdependent to a considerable extent. For those Independent States determined to go entirely their own way it was clear that an unconsidered disengagement from their sister republics would cause serious economic disruption and hardship. For those Independent States inclined to seek common solutions to shared problems, it was evident that the advantages of a larger market and harmonised legal regulation needed some sort of formal structure to maintain, formulate and administer these policies.

On 8 December 1991 the Independent States formed an entity called the Commonwealth of Independent States (the CIS). All 12 signed the Agreement, although Georgia has declined so far to participate and Azerbaidzhan has not completed all the formalities of involvement in the Commonwealth even though often sending observers to Commonwealth events.

The principal organs of the CIS are the Council of the Heads of State of Participant-Countries and the Council of the Heads of Government of Participant-Countries. In September 1992 a new body, the

Inter-Parliamentary Assembly of the CIS, held its first session at Bishkek, Kyrgyzstan. The CIS has a permanent secretariat at Minsk, Belarus. Various committees and commissions have been created to perform or co-ordinate individual functions.

Although the CIS has been concerned to a certain extent with joint security issues, the greater portion of its activity relates to economic and legal co-operation. The organisation works on the principle of consensus, usually recorded in individual treaties and agreements devoted to specific domains of collaboration. Most of these concern economic matters and hence are of direct import for the investment community. On 15 September, 9 October and 28 December 1992 the CIS adopted key documents concerning the approximation of economic legislation, including investment, customs, environmental, transport, enterprise, tax and other laws. If those documents are fully complied with (so far six States, including Russia, have accepted them), the Independent States will collaborate to a much greater extent than at present to develop model laws or to approximate and adopt key economic enactments simultaneously.

CIS documents will be as vital for the investment community as the laws of the respective Independent States.

## **1.2 The effect of Russian independence on the legal framework**

The political and economic troubles of the Russian Federation have received considerable publicity. The inadequacy and inconsistency of legislation relating to such key areas as privatisation, natural resources and currency regulation has been subject to criticism by foreign investors and international organisations alike. Yet, in retrospect, few could have predicted that political and legal developments would have progressed so quickly from December 1991, when the old political and legal system of the USSR had continued to dictate much of the foreign investment regime.

Discouraged by mass media reports of economic and political instability, some foreign investors have postponed their decision to invest in the Russian Federation. Others are quietly forging ahead, establishing joint ventures and other commercial arrangements. In doing so, they are gathering invaluable experience and establishing footholds in many industry and service sectors.

What is the legal framework for such investment? While many mistakes have been made by the Russian Government and Parliament during the past two years, a review of the legislative developments reveals the emergence of an increasingly sophisticated market-based system of laws, within a surprisingly short period of time. Detailed legislation relating to taxation, the regulation of banking activities and securities and commodities exchanges, the issuance and registration of securities, intellectual property and the exploitation and protection of natural resources has been adopted. The Russian Federation adopted a law on pledge in 1992 (see Appendix 2) which for the first time recognised the right to pledge all forms of property which may be alienated by the possessor (although unfortunately, establishing priority interests may not be possible because no mechanism to establish such rights was expressly included in the law). A law on bankruptcy was adopted in November 1992 (with effect from 1 March 1993), and legislation relating to privatisation has been implemented and supplemented as the process reveals shortcomings in the legal and socio-economic framework.

To understand the Russian Federation legal framework for investment, it is necessary to look first to the continuing influence of a system which dissolved nearly one year ago and its would-be successor, the CIS.

As discussed previously, 12 of the republics of the former Soviet Union, including Russia, signed the Agreement on the Creation of the Commonwealth of Independent States (the 'CIS Agreement'). The CIS Agreement was an ambitious, albeit fledgling, attempt to provide substantial co-ordination in a number of fundamental areas. While political and economic differences among the CIS member states have prevented agreement on broad scale co-ordination of laws, many republics, including the Russian Federation, have nevertheless entered into bilateral agreements relating to various issues, for example, customs and organised crime.

Perhaps the most significant result of the CIS Agreement has been the resulting documents, noted above, relating to unification and harmonisation of laws in various fields, including communications, taxes, currency and customs signed by the Russian Federation, Armenia, Belarus, Kazakhstan, Kyrgyzstan, Tadzhikistan and Uzbekistan (the latter four states forming part of Central Asia). The



Central Asian states have, in general, been favourably disposed towards the Russian Federation and in many ways such an alliance could be economically advantageous for all parties.

### 1.2.1 The continuing influence of Soviet legislation

While the CIS has thus far been a largely unsuccessful force in influencing Russian legislation affecting foreign investment, the same cannot be said of the defunct Soviet Union. The Russian Federation asserted its sovereignty long before the 'constitutional' dissolution of the Soviet Union in December 1991. On 12 June 1990 the Congress of People's Deputies of the RSFSR asserted the state sovereignty of the RSFSR and the supremacy of its laws. Thus began the 'war of laws' within the Soviet Union. By late 1991, foreign investors and their advisers frequently found themselves in the middle of this war, especially in the area of regulation of exploration and exploitation of natural resources (for example, timber, oil, gas and minerals) and use or development of land and structures. They were faced with conflicting USSR and Russian legislation and conflicting assertions of rights of ownership.

At the time of the dissolution of the Soviet Union, the Russian Federation had adopted considerable legislation and was well on the way to the creation of a comprehensive legal system. It recognised, however, that there remained significant gaps in its legal framework and sensibly decreed (upon ratification of the CIS Agreement) that the legislation of the USSR would continue to be applied on the territory of the Russian Federation, until the adoption of similar legislation, to the extent not contrary to the Constitution or legislation of the Russian Federation. This formula has also been the source of difficulties for the foreign investor.

While such an approach made the transition to *de facto* sovereignty smoother, it also resulted in the survival of legislation which was inconsistent with a market economy. There continues to be uncertainty as to whether Soviet legislation remains in force in cases where Russian Federation legislation relates to the same subject matter as earlier Soviet legislation but is not as comprehensive. Examples of questions arising because of this lack of clarity are discussed elsewhere in this book.

### 1.2.2 The new 'war of laws' within the Russian Federation

It is hoped that by early 1993 the Russian Federation will have formally severed its connection with the Soviet regulatory legacy. Investors will then be able to focus on a more recent development — the 'war of laws' within the Russian Federation. This development is a natural one in a vast country comprising numerous distinctive nationalities and in which the constituent republics have varying levels of natural resources and industrial capacity.

As is discussed in chapter 2, 'Sources of law in Russia', the Russian Federation comprises several republics and various subordinate administrative-territorial structures. In recognition of the need to define the relationship between federal, republic and other subordinate jurisdictions, representatives from the Russian Federation and the republics within the Russian Federation (the two exceptions being Tatarstan and Chechnia) signed one of three Treaties of the Federation on 31 March 1992. Many foreign investors took little or no notice of these treaties, which do, however, have potentially enormous implications for their investments.

The treaties set forth areas within the exclusive jurisdiction of federal agencies or joint jurisdiction of the parties and provide that all other areas are relegated to the exclusive jurisdiction of the republics. The effect of the treaties is to relegate to federal agencies exclusive jurisdiction over matters relating to, for example, currency, customs, foreign policy and defence. Federal agencies are also given jurisdiction to issue legislation in the form of 'fundamental principles' in a number of key areas of joint jurisdiction, including, for example, taxation, labour, environmental protection, public health and natural resources. Republics are permitted to adopt subordinate legislation in areas of joint jurisdiction to the extent consistent with federal legislation.

For the foreign investor, this development has a number of consequences. Foremost, the investor must in many cases negotiate with authorities and comply with legislation at both the federal and republic (or lower) level for the purpose of creating joint ventures in industry sectors such as timber, oil and gas and other natural resources. A number of republics, such as the Komi Republic, have been quick to adopt legislation, particularly in the area of natural resources. This legislation in a number of instances has been inconsistent with federal legislation.

While weaknesses in the current framework exist, the objective of decentralising decision making sufficiently to encourage market forces to work at lower levels is a good one, and is in stark contrast to the former centrally-controlled command system.

It can be expected, however, that republics which are rich in natural resources will continue to press for further economic, if not political, sovereignty. Finding a mutually beneficial compromise is one of the greatest challenges facing the Russian government.

### **1.3 Prospects for change in the legal framework**

Whatever shape the processes of economic reform in Russia take, legal change will be the order of the day. Those doing business or investing in Russia should expect substantial change throughout at least the remainder of this century, hopefully for the better. In this, Russia will differ from other developed legal systems only in the fundamental nature of many of the changes, not in the frequency.

It may be helpful to think of likely changes falling into three categories:

- (1) the enactment of legislation completely lacking;
- (2) the replacement of the 'first generation' of legislation with the 'second' and 'third' generations; and
- (3) the adoption of 'strategic programmatic' legislation.

By the end of 1992 there was virtually no legislation fundamental to a market economy that could be said to be wholly lacking. The adoption in November 1992 of the law on bankruptcy finally filled the last major gap. Most market economy legislation, however, is 'first generation' legislation, a mixture of early concepts of the market, compromises of a political and legal nature with the previous legislation of the planned economy, and a reflection of the vagaries of the sundry philosophies of economic reform propounded from month to month in Russia.

Legislation of the 'second generation' will treat ownership, pledge, lease, all types of company, currency, customs, foreign investment, banking, insurance and others. Taxation legislation will soon embark upon its third generation of reform.

While Russia already has experienced several cycles of economic reform philosophy, law has not occupied a central role in any of them — one of the reasons no doubt that each reform cycle has brought less than was anticipated. Nonetheless, macro-economic policies carry legal implications: reforms intended to accelerate market forces will encounter obstacles in existing legislation insofar as such legislation contains provisions not consistent with a market philosophy. Likewise, if a go-slow approach is adopted with respect to the market, difficulties will be experienced with those domains of legislation whose premises are designed to facilitate the introduction of a market economy. No company doing business in Russia should omit to monitor the legal implications of economic reform strategies.

Another factor is likely to become more prominent in the processes of law reform. Russia has a code-based legal system, as had the former Soviet Union. Most 'first generation' reform legislation has consisted of individual laws and other enactments rather than full-scale codes, although a land code has been adopted. These individual enactments supersede in part the pre-existing Russian codes, but not entirely. Russian legislation in this transition era consequently has lost much of its traditional coherence and symmetry. Pressures are building to restore this coherence at the second and third generations by amalgamating individual laws into full-scale market-orientated codes: for example, the incorporation of the laws on ownership, lease, pledge, patents, copyright and the like into a new civil code and possibly a trade code.

The process of 'recodification' is likely to be accompanied by organised Western law reform assistance from a variety of European sources. The business and investment climate will be improved if these reforms are successful in drawing upon and adapting the leading legal models abroad.



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## 2 Sources of law in Russia

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The subject of this chapter is, in the West, ordinarily reserved to learned works on jurisprudence or legal theory. For the company setting up in Russia, however, few topics are of greater concern. Many companies investing in Russia will find themselves in circumstances where a formal legal opinion is required with respect to the most basic questions of law, questions which in the West would be taken for granted but which in Russia can fundamentally alter the viability of a transaction. The reasons lie partly in Russia's authoritarian past, but mostly in the nature of the administrative-command system associated in Soviet experience with the Planned Economy.

The questions are straightforward enough — what is law? Where and how is it to be found?

Unlike the English language, but in common with most other European tongues, the Russian language has two principal terms for law. The first, *pravo* (право), refers to law in the broadest sense of the word, what the French call *droit* and the Germans, *Recht*. Where *pravo* originates is a subject of much debate: in post-Soviet Russia a growing body of opinion equates *pravo* with natural law, or a community-based unwritten law which takes precedence over all others. The debate over the so-called 'rule-of-law State' in Russia turns to a considerable extent on the understanding of which 'law' is to represent the 'rule of law'.

The second term, *zakon* (закон), is man-made law which originates at the highest level of the State. In the case of Russia, only the Congress of People's Deputies or the Supreme Soviet of the Russian Federation are empowered to adopt laws in this sense. On the principle of parliamentary sovereignty, laws adopted by parliament, including the Constitution, must be supreme: however, adherents of the supremacy of *pravo* believe that no Russian parliament has the right to adopt *zakon* which are contrary to *pravo*.

Investment is affected by this debate in many key respects. One of the most salient examples is the question of the ownership to natural resources in Russia and who has the right and power to dispose of them. Russian legal documents from 1978 began to speak of natural resources being the 'weal' of the 'people', a doctrine which contains natural law elements and implies, in some interpretations, that neither the State nor Parliament may have the power to convey title on behalf of the people to others. In more modern formulations that doctrine has been attenuated by making the State or Parliament the representative of the people for these purposes, impliedly conferring the power to convey title on the State. This debate is far from over, and it stems not from questions of ownership, but rather from questions of what is law and who has the power to make it.

### 2.1 Hierarchy of legal rules

Russia has inherited the approach of the former Soviet Union to sources of law. If the highest man-made law is *zakon*, and the Constitution the highest of such, all other law is 'subordinate' legislation (подзаконный, literally 'sub-law'). Subordinate legislation must be in conformity with *zakon*. Often, however, it fails to meet this standard, not least because the legislator traditionally gives enormous discretion to those who create subordinate legislation to act 'on the basis of and in execution of' laws.

Hierarchy with respect to law has two dimensions: the stature of the issuing person or agency, and the nature of the enactment itself. The introduction of a separation of powers and of a Presidency in the Russian Federation has greatly complicated the picture. The following examples illustrate both dimensions of hierarchy and some of the dilemmas that accompany the principle of separation of powers.



### 2.1.1 The Congress of People's Deputies and the Supreme Soviet of the Russian Federation

Both of these bodies enact laws (*zakon*). They also enact decrees (постановление) and through laws and decrees confirm a vast variety of enactments: reglament, code, statute, fundamental principles, programme and others. Examples include:

- (1) the Reglament of the Congress of People's Deputies, which contains the rules of procedure by which the Congress and Supreme Soviet conduct their affairs;
- (2) the statute on licensing the use of the subsoil (which was in fact confirmed by a Decree of the Supreme Soviet and does not enjoy the stature of a law);
- (3) Fundamental Principles of particular legislation where jurisdiction over matters is shared with the republics within the Russian Federation;
- (4) the State Programme for the Privatisation of State and Municipal Enterprises, which was confirmed by a law; and
- (5) decrees appointing senior governmental officials, ambassadors etc, and conferring State awards, treating matters of citizenship and the like.

In some cases decrees are adopted by the Presidium of the Supreme Soviet, although as a rule these are concerned with procedural matters. What is 'procedural' can also be of vital importance for investors. In March 1992 the Presidium of the Supreme Soviet, by way of decree, stipulated that the participatory shares, shares, or stocks held by 'State structures' had passed to the State Property Fund. In September 1992 many joint enterprises created in Russia received form letters on the basis of this decree requesting them to submit documents confirming that the State Property Fund had now become their participant or stockholder in place of the former 'State structure'.

For companies who have been doing business in Russia for many years, this outburst of parliamentary activity is bewildering. In the old days Parliament met twice a year for two or three days and enacted at best only a tiny handful of laws. Its plenary body, the Presidium, was the collective Head of State and issued edicts in the intervals between sessions of the Supreme Soviet which were subject to subsequent confirmation by the Supreme Soviet. It was a tidy, uncomplicated, highly structured and programmed exercise. No more. Parliamentary politics are maturing in Russia as experience accumulates, and the law-making process is becoming increasingly complex and sophisticated.

Enactments of the Congress of People's Deputies and the Supreme Soviet are published officially in the newspaper *Rossiiskaia gazeta* and in a weekly official gazette, *Vedomosti s" ezda narodnykh deputatov i verkhovnogo soveta Rossiiskoi Federatsii*. The official gazette normally appears about a month after its cover date, which means the newspaper versions of the enactments are indispensable.

### 2.1.2 Constitution

A special word needs to be said about the Constitution of the Russian Federation. In the Soviet era constitutions were to a significant extent symbolic and programmatic documents. They portrayed a political and legal order which did not exist in reality, and a large number of their provisions were orientated towards the achievement of future social objectives and programmes.

Under *perestroika* doctrines emerged which would confer a genuine rule-of-law stature on the Constitution. These have yet to finally prevail. The Russian Federation continues in the winter of 1992 to operate on the basis of its 1978 Constitution which has been amended considerably, and to promise a new Constitution in the immediate future, possibly sometime in 1993.

The Constitution currently in force is a bizarre document. It consists of the original 1978 text in heavy Soviet legalese, with amendments since 1989 charting key economic, legal and political reforms (for example, ownership relations, the Presidency and the role of the courts), and clauses which are simply obsolete or anomalous because the Congress of People's Deputies could not produce the requisite two-thirds majority to amend the text. References to the USSR remain in the text even though the Union is extinct.

It is in this document that the legal fabric will, or will not, be fashioned for a market economy to