

AZERBAIJAN PRACTICE

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Doing Business in Azerbaijan March 2004

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PREFACE

Baker & McKenzie was established 55 years ago, and now has 68 offices in 38 jurisdictions. The Firm established a truly global presence, with an office in each of the world's major money centers.

We established a presence in Baku in April 1998 and on October 20 of that year became the first international law firm to be licensed to practice law in Azerbaijan. Today our work includes a full range of legal services for foreign investors doing business in Azerbaijan. Baker & McKenzie now has the largest legal practice in the former Soviet Union.

Since gaining its independence in 1991, Azerbaijan has adopted new laws at a rapid pace. It remains a country in transition and its legal system is continuing to develop. Therefore, we have prepared *Doing Business in Azerbaijan* as a general guide for those companies or persons considering making an investment in Azerbaijan. As the legal landscape continues to change frequently, this document should be taken as a basic guideline intended to assist investors in understanding Azerbaijan's overall investment climate and cannot be relied upon as legal advice in relation to any transaction as a substitute to seeking specific legal advice.

We will be happy to provide you with updates on the material contained herein or to provide you with further information regarding a specific industry or area of Azerbaijani law in which you may have a particular interest.

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1. AZERBAIJAN - AN OVERVIEW

1.1 Location, Area and Topography

Three physical features dominate Azerbaijan: the Caspian Sea, its shoreline forming a natural boundary to the east; the Greater Caucasus mountain range to the north; and the extensive flatlands at the country's center. About the size of Portugal and the state of Maine, Azerbaijan has a total land area of 86,600 square kilometers. Of the three Transcaucasian states, Azerbaijan has the greatest land area. Azerbaijan also has a special administrative subdivision, the Nakhchivan Autonomous Republic, which is separated from the rest of Azerbaijan by a strip of Armenian territory.

Located in the region of the southern Caucasus Mountains, Azerbaijan borders the Caspian Sea to the east, Georgia and Russia to the north, Iran to the south, and Armenia to the southwest and west. A small part of Nakhchivan also borders Turkey to the north-west. The capital of Azerbaijan is the ancient city of Baku, which has the largest and best harbor on the Caspian Sea and has long been the center of the region's oil industry.

The climate varies from subtropical and dry in central and eastern Azerbaijan to subtropical and humid in the southeast, temperate along the shores of the Caspian Sea, and cold at the higher mountain elevations. Baku, on the Caspian, enjoys mild weather, averaging 4°C in January and 25°C in July. As most of Azerbaijan receives scant rainfall (an average of 152 to 254 mm annually), agricultural areas require irrigation. The heaviest precipitation occurs in the highest elevations of the Caucasus and in the Lenkoran lowlands in the far southeast where annual precipitation 1,000 mm.₁

1.2 Demographics

In October 1999, Azerbaijan celebrated the birth of its 8 millionth citizen. At

the beginning of 2003, Azerbaijan's population was 8,202,000 with an annual growth rate of 0.7%. Approximately 30% of the population is under 15 years old; 61% is between 16-61 years old; and 9% is over 61. Azerbaijanis account for 90.6% of the population, the remainder being Daghestani, Russian, Armenian and other minorities.²

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¹ United States Library Congress, <http://lcweb2.loc.gov/frd/cs/aztoc.html>

² United States Library Congress, <http://lcweb2.loc.gov/frd/cs/aztoc.html>

Approximately 50.7% of Azerbaijanis reside in urban areas, the remainder live in rural regions. The overall population density is about 90 persons per sq. km. Thirty-five percent of the approximately three million members of the labor force work in the agricultural and forestry sectors, 26% work in industry and construction, with balance in other occupations.

While Azerbaijan is constitutionally a secular state, the vast majority (93.4%) of the population is Muslim. The official language is Azerbaijani, a Turkic language.

1.3 History

Azerbaijan's history is deeply rooted in the ancient period. In the Ninth Century B.C., the semi-nomadic Scythians settled in areas of Azerbaijan. A century later, the Medes, who were related ethnically to the Persians, established an empire that included southernmost Azerbaijan. In the Sixth Century B.C., the Archaemenid Persians, under Cyrus the Great, took over the western part of Azerbaijan when they subdued the Assyrian Empire to the west. In 330 B.C., Alexander the Great absorbed the entire Archaemenid Empire into his holdings, leaving Persian satraps to govern as they advanced eastward. According to one account, Atropates, a Persian general under Alexander's command, whose name means "protected by fire," lent his name to the region when Alexander made him its governor. Another legend explains that Azerbaijan's name derives from the Persian words meaning "land of fire," a reference either to the natural burning of surface oil deposits or to the oil-fueled fires in temples of the once-dominant Zoroastrian religion. From the First Century A.D., Zoroastrianism in the south and central areas and Christianity in the north were the predominant religions in ancient Azerbaijan.

Between the First and Third Centuries A.D., the Romans conquered the Scythians and Seleucids, who were among the successor groups to Alexander's fragmented empire. The Romans annexed the region of present-day Azerbaijan and called the area Albania. As Roman control weakened, the Sasanid Dynasty reestablished Persian control. In the Seventh Century, Arabs conquered Azerbaijan, bringing Islam with them. After the Ninth Century, Arab rule weakened and several small independent states came into being.

In the Mid-11th Century, Turkic-speaking groups, including the Oghuz tribes and their Seljuk Turkish dynasty ended Arab control by invading Azerbaijan from Central Asia asserting political domination. The Seljuks brought with them Turkish language and customs. By the 13th Century, the basic

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characteristics of the Azerbaijani nation had been established. Several masterpieces of Azerbaijani architecture and literature were created during a cultural golden age that spanned the 11th through 13th Centuries. Among the most notable cultural monuments of this period are the writings of Nizami Ganjavi and the mausoleum of Momine-Khatun in Nakhchivan.

Under the leadership of Hulegu Khan, the Mongols invaded Azerbaijan in the early 13th Century. Hulegu ruled Azerbaijan and Persia from his capital in the Persian city of Tabriz. At the end of the 14th Century, another Mongol, Timur (also known as Tamarlane), invaded Azerbaijan at about the same time that Azerbaijani rule was reviving under the Shirvan Dynasty. Shirvan Shah

Ibrahim ibn Sultan Muhammad briefly accepted Timur as his overlord. (In earlier times, the Shirvan shahs had accepted Seljuk rule.) Another extant architectural treasure, the Shirvan Shah Palace in Baku, dates from this period. In the 16th Century, the Azerbaijani Safavid Dynasty took power in Persia. This dynasty fought off efforts by the Ottoman Turks during the 18th Century to establish control over Azerbaijan; the Safavids could not, however, halt Russian advances into the region.³

The end of the 19th Century was characterized by the oil boom in Baku, which became the “oil capital of the world.” In the late 1890s, the annual oil output was 11 million tons, or more than 48% of the world total.

On May 28, 1918, Azerbaijan declared independence from Russia and founded the Azerbaijan Democratic Republic, becoming the first secular republic in the Islamic world. In April 1920, Azerbaijan was occupied by the Red Army and became part of the USSR in 1922. On October 18, 1991, after the disintegration of the USSR, Azerbaijan declared its independence and succession to the 1918 Azerbaijan Democratic Republic.

Under the domination of the Soviet Union for most of the 20th Century, Azerbaijan began a period of tentative autonomy when the Soviet state collapsed at the end of 1991. A culturally and linguistically Turkic people, the Azerbaijanis have retained a rich cultural heritage despite long periods of Persian and Russian domination. In the 1990s, the newly independent nation still faced strong and contrary religious and political influences from neighbors such as Iran to the south, Turkey to the west, and Russia to the north. Furthermore, in the early 1990s, a long military and diplomatic

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³ United States Library Congress, <http://lcweb2.loc.gov/frd/cs/aztoc.html>

struggle with neighboring Armenia was sapping resources and distracting the country from the task of devising post-Soviet internal systems and establishing international relations.

In response to the separatist sentiments of the Nagorno-Karabakh region’s ethnic Armenians, a popular nationalist movement developed in the late 1980s. This movement acted to thwart the secessionist claims of Armenians in Nagorno-Karabakh and protect the territorial integrity of Azerbaijan. By and large, the movement subsequently formed the basis of the Azerbaijan Popular Front led by Abulfaz Elchibey, who was elected president in June 1992. The principal tenets of the Popular Front were national independence and closer unity among Turkic states. However, due to internal instability and territorial losses in Nagorno-Karabakh after major military defeats, Abulfaz Elchibey *de facto* surrendered the President’s office to Heydar Aliyev in June 1993.

1.4 Government Organization

The current *Constitution of the Republic of Azerbaijan* was ratified by popular referendum in November 1995 and amended in August 2002. It contains a system of checks and balances aimed at securing separation of powers among the legislative, executive and judiciary branches of the government. The Constitution provides for a unicameral parliament (the National Assembly or *Milli Majlis*), a president and a prime minister. The members of the National Assembly are elected for five-year terms. Prior to the recent amendments, the Constitution provided for majority vote and proportional representation electoral systems for the elections to the National Assembly. Following the amendments, however, the National Assembly members will be elected by majority vote only.

The President is elected for a five-year term by popular vote. He is the head of the executive branch and, with the consent of the National Assembly, appoints the Prime Minister. The President directly appoints members of the Cabinet of Ministers.

Judicial power in Azerbaijan is exercised by a court system whose independence is guaranteed by the Constitution. The Constitutional Court decides issues relating to the form and substance of laws and other acts of authorized agencies, court decisions and international treaties concluded on behalf of the Republic of Azerbaijan. It resolves disputes among the branches of government and interprets the Constitution and the laws of the Republic of Azerbaijan with

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regard to the human rights and fundamental freedoms of individuals. The recent amendments have also authorized the Constitutional Court to directly hear cases by physical persons claiming violations of their human rights and fundamental freedoms. The Supreme Court is also the court of last resort for all civil, criminal, administrative and other matters.

1.5 Results of Elections and Political Considerations

The current president, Ilham Aliyev, was elected in October 2003. As a result of the 2000 parliamentary elections, the majority of the National Assembly seats are held taken by members of the New Azerbaijan Party, established by former president Heydar Aliyev.

The political situation is stable. Establishment of a cease-fire with Armenia and suspension of active military operations in the Nagorno-Karabakh region has contributed much to this stability.

1.6 Foreign Relations and International Organizations

Azerbaijan became a member of the Commonwealth of Independent States (the "CIS") in September 1993. The major obstacle to Azerbaijan's increased involvement in this organization has been the unresolved sixteen-year-old conflict over the Nagorno-Karabakh region. Both sides of the conflict have generally observed a Russian-mediated cease-fire in place since May 1994 and support the OSCE-mediated peace process. Nevertheless, the parties remain far apart on most substantive issues from the placement and composition of a peacekeeping force to Nagorno-Karabakh's ultimate political status.

Azerbaijan has joined several major international organizations since gaining its independence. It is a member of the UN, OSCE, Council of Europe, EBRD, World Bank, IMF, Interpol, the Black Sea Region Countries Cooperation Union, the Black Sea Trade and Development Bank, Asian Development Bank and other international and regional organizations.

Azerbaijan has observer status at the WTO. Azerbaijan has also joined NATO's "Partnership for Peace" program.

Since gaining independence, Azerbaijan has maintained very close relations with Turkey, with which it shares a similar language, culture and religion.

Turkey was the first country to recognize Azerbaijan as an independent state.

In line with its course to build a democratic, secular and civil society,

Azerbaijan is also trying to secure a strategic partnership with the United States.

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1.7 Economy

1.7.1 Background

Azerbaijan possesses fertile agricultural lands, rich industrial resources, including considerable oil reserves, and a relatively developed industrial sector. Utilization of those resources in the Soviet period, however, was subject to the usual distortions of centralized planning. In the early 1990s, economic output declined drastically. The major factors in that decline were the deterioration of trade relations with the other former Soviet republics, the conflict in Nagorno-Karabakh, erosion of consumer buying power, and retention of the ruble alongside the national currency.

Most of Azerbaijan's 3,500 industrial enterprises are located in Baku, Sumgait, and Ganja. Heavy industry consists of petroleum extraction and refining equipment, metallurgy, aluminum mining and refining, petrochemicals, and

chemical production. Light industry consists of food processing, textiles, and wine production. Baku's main industries are oil and gas equipment and light manufacturing; Sumgait's production centers on chemical and petrochemical production, textiles and aluminum smelting; Ganja is home to an aluminum refining plant and also specializes in textiles, machine building and metallurgy. Although industrial production grew during the late 1980s, due to the collapse of the USSR, the disruption of economic ties with other countries of the former Soviet Union and the conflict with Armenia over the Nagorno-Karabakh region (approximately 16% of Azerbaijan's territory is occupied and controlled by separatists), the economy has significantly declined for several years. Thus, the rate of economic growth was a negative 22% in 1994 compared to 1993 year indices. By 1995, output had declined 50% in the petrochemical and machine-building industries, with less dramatic declines in light industries.

A decline was also reported in the agricultural sector of economy, a critically important sector in Azerbaijan employing about 35% of the labor force. Cotton is Azerbaijan's leading cash crop, followed by wine grapes, fruits, vegetables, and tobacco. Much of that production, however, never reaches foreign markets. Food storage, processing and packaging technologies are needed to fully utilize Azerbaijan's agricultural potential. The privatization of agriculture is expected to stimulate rapid growth in the agricultural sector.

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Despite the economic difficulties of the early 1990s, positive growth in Azerbaijan's economy has been reflected in the economic data set out below. Investment in the oil sector, the long awaited oil production from fields developed by the first international oil consortium in Azerbaijan, completion of the Baku – Supsa (Georgia) oil pipeline, and the current construction of the Baku-Tbilisi-Ceyhan oil pipeline and South Caucasus gas pipelines have had a determinative impact on Azerbaijan's economic growth in recent years.

1.7.2 Gross Domestic Product

GDP for 2002 rose by approximately 10.6% over the previous year. For 2002, the GDP composition was: industry – 38.4%; agriculture – 10.2%; construction – 11.7%; transport and communication – 10.2%; other services – 29.5%.

1.7.3 Employment, Wages and Inflation

Official unemployment figures for the beginning of 2002 put the number of unemployed people at 50,963. In reality, though, taking into consideration the large number of internally displaced persons from Nagorno-Karabakh, there are over 1 million unemployed. Additionally, many of Azerbaijan's workers are idle or forced to take unpaid leave.

For 2002, the average nominal wage was approximately US \$64.

During the last half of 1994, Azerbaijan was teetering on the brink of hyper-inflation. During November and December of 1994, monthly retail price increases exceeded 50%. During the last quarter of 1994, the Government of Azerbaijan worked closely with the IMF on a Structural Transformation Facility (STF) program. The National Bank tightened the credit policies of state-owned banks and halted interest-free loans to moribund state enterprises. The Ministry of Finance put together a restrictive budget for 1995, which the National Assembly passed. The government also eliminated huge consumer subsidies for gasoline and bread. As a result, the rate of retail inflation fell dramatically. Inflation in 1997 was only 3.7% and has remained low since. The exchange rate of the manat, the local Azerbaijani currency, now stands at approximately