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# Modernizing Contract Enforcement Lessons from Russia

This Best Practice was adapted from "Doing Business 2007: How to Reform Case Study: Enforcing Contracts—Russia," prepared by Booz Allen Hamilton in cooperation with USAID for the World Bank Group's 2007 Doing Business Reformers Club Conference.

## Executive Summary:

*In order to address the needs of its increasingly complex market economy, Russia created arbitrage courts and forums for alternative dispute resolution. It also attempted to improve the financial condition of the courts, reduce corruption, and ensure prompt enforcement.*

## Introduction

Effective enforcement of contractual rights requires a reliable system for the adjudication of commercial disputes and effective mechanisms for the enforcement of these decisions. Foreign investors often shy away from Russia and economies in transition because they doubt their rights will be upheld in local courts. In an effort to ensure proper adjudication, Russia made the following judicial reforms: established arbitrage courts and revised arbitrage procedures; created alternative forums for resolution of commercial disputes; improved the financial condition of the courts; introduced anticorruption measures; and ensured enforcement of judicial decisions through the newly established Office of Bailiffs.

The reform efforts were motivated by the desire to bring the Russian judicial system into compliance with international standards and to raise its status in the eyes of the Russian and international public. However, the Russian judicial system often continues to be perceived as inefficient and untrustworthy. Effecting real change requires changing mind-sets as well as laws.

## Context, Approach, and Results

The fundamental motivation behind judicial reform in Russia was the changing political and economic situation. With the collapse of the Soviet Union, a number of new concepts

were introduced, such as private property, the right to engage in contracts, entrepreneurship, foreign direct investment, and securities. The judicial system established during Soviet times was not designed to adequately address disputes arising from these new economic relations. The dismal financial condition of the court system, corruption, and the lack of proper enforcement mechanisms further exacerbated the situation. Thus, Russian and foreign entrepreneurs could not rely on the Russian courts to effectively address commercial disputes. Judicial reform in Russia began in 1991 and encompassed a number of measures aimed at improving the court system.

## Arbitration

Since their creation, arbitrage courts were hindered by an increasing caseload and inefficient procedures. Economic development, the introduction of new legislation and commercial practices, and the increasing sophistication of business transactions continuously increased the scope and complexity of the work facing these courts. Between 1991 and 2005, the number of court cases filed in arbitrage courts increased steadily by about 20 percent per year. However, the increase in the caseload and broadening of court authority was not accompanied by a corresponding increase in staff and technical support for the courts.



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The new Arbitrage Procedural Code adopted in 2002 introduced two major innovations—a mandatory preliminary hearing for most cases and an accelerated procedure for the consideration of uncontested cases with “insignificant” amounts at stake. Under the accelerated procedure, judges were allowed to resolve cases on the basis of pleadings instead of a full hearing. The code also set mandatory time frames for resolving disputes: two months for a full hearing and one month for an accelerated procedure. Federal Law “On Amendments” established appellate arbitration courts as separate entities, lengthened the time from the initial judgment until the appeal, and increased the deadline for submitting a secondary appeal to a federal district arbitration court from one to two months. Federal Law “On Arbitration Assessors” introduced the right of either party to demand that a case be heard by two assessors in addition to a judge. In addition, Federal Law No.137 and changes in the tax code allowed pension and tax authorities to collect certain debts directly, without a court order.

The opinion among practicing lawyers is that the new code was developed without wide public discussion, and most attorneys and judges were unaware of it until it was adopted. Despite a sense of surprise, there was no notable opposition to the reforms. The procedural changes in arbitration courts ostensibly improved the protections afforded to the rights of regular citizens, but they also increased the number of loopholes available to experienced lawyers for intentionally delaying and manipulating the proceedings to suit their clients’ interests.

The perception among some in the international legal community is that arbitration judges lack competence in complex cases and can be unwilling to consider new concepts and unfamiliar details of transactions. Russian attorneys say that competence varies by individual judge.

The requirement for a mandatory preliminary hearing contained in the 2002 Code has caused additional delays of at least one month in cases that would have been decided in a single hearing under the old code. While the usefulness of a preliminary hearing is clear in complex cases, the new code does not allow the judges to bypass it in simple cases. Introduction of the expedited procedure has made a major difference for the courts where the judges have embraced it. However, the courts do not use it consistently throughout the country.

In practice, due to imperfections in the law, the use of arbitration assessors has caused further procedural delays. First, cases involving assessors can be postponed indefinitely if an assessor is not present because the law provides no penalties for an assessor missing a court date. Second, although the procedure was intended for use in more complex cases, in reality it can be used in virtually any case, thereby unnecessarily delaying simple cases such as payment of rent. Third, while it is helpful to have industry experts serve as assessors in cases requiring specialized expertise, the law provides insufficient guidance on selection and qualification of assessors.

In the first half of 2006, the number of cases brought to enforce contractual obligations increased by 6 percent as compared to 2005; 62 percent of these cases related to insurance and 76 percent of disputes related to failure to pay for goods or services received. There was a significant increase in the number of cases enforcing intellectual property rights (from 445 in the first half of 2005 to 728 in the first half of 2006). At the same time, the number of insolvency filings quadrupled from 10,855 in the first half of 2005 to 47,411 in the first half of 2006.

The reduction in the number of simple tax cases is particularly significant for the Moscow arbitration court, which has jurisdiction over all tax matters for major Russian companies and has 32 judges on staff focusing only on tax matters. These judges are now able to devote a greater amount of time to more complex cases raising novel legal issues. Although precedent has no legal significance, decisions of Moscow courts serve as important references for other courts that have less experience in such cases.

### *Alternative Dispute Resolution (ADR)*

Most international contracts specify international arbitration in a neutral forum as the first choice for dispute resolution, since mechanisms for ADR often function more efficiently than courts. Until 2002, such mechanisms did not exist in Russia and arbitration courts were the only forum for resolving commercial disputes. These courts were overloaded and unable to adequately meet the needs of the business community.

Federal Law “On Treaty Courts in the Russian Federation” (2002) established the first alternative to the arbitration courts. The concept of treaty

courts includes formally established permanent treaty courts as well as temporary arbitration panels created to resolve a particular disputes. A contract dispute will be heard in a treaty court only if this was specified by the contract terms; otherwise it will go to arbitration courts. Treaty courts have no jurisdiction over disputes with tax authorities or other governmental agencies. The system allows the parties to choose the judges whose opinion and expertise they trust. This right is particularly important for disputes demanding a high level of specialized expertise such as intellectual property or complex financial transactions.

In the past few years, hundreds of treaty courts have been established throughout Russia. An average proceeding in a treaty court takes 40 days; the issuance of a judgment takes another 30 days. This is about two months shorter than an average arbitration court proceeding. The fees charged by treaty courts vary widely, with some courts charging less than arbitration courts and some much more. Still, according to legal advisor A.L. Rappoport, about 95 percent of commercial cases in Russia are brought in arbitration courts and only 5 percent in treaty courts.

#### *Financial Condition of the Courts*

In the early 1990s the financial situation of the courts was dire. By 1995, courts were often unable to pay for utilities or office supplies and routinely missed payroll. Lack of proper facilities impaired the transparency of the judicial process since public hearings were conducted in private simply because there was no space to accommodate observers from the public or the press. Delays created fertile grounds for corruption where bribes were offered to expedite administrative processes.

Under the 2002–2006 Federal Target Program, 105 court buildings were refurbished, design documentation was developed for the construction of 21 new buildings, and 22 court facilities were acquired.

Observers comment that the condition of the courts has improved dramatically since the 1990s. However, many court facilities still do not allow adequate public access to hearings or transcripts of decisions. As a result of the 2002–2006 program, 90 percent of all regional courts and 50 percent of all district courts received computer workstations. There is a fully operational website for the arbitration court system providing information on the structure and operational pro-

cedures of the courts, relevant legislation, and other matters. It also contains a search engine for pending and decided arbitration court cases.

#### *Anticorruption*

According to a poll conducted by the Public Opinion Foundation in February 2001, 72 percent of respondents said that legal reform was necessary, 71 percent of respondents believed that Russian courts were guided by factors other than the law, and 58 percent believed that judges often reached unfair verdicts. Increased transparency was required to improve public trust in the system and increase public participation in the judicial process.

Federal Law "On the Status of Judges" established the inviolability, independence, and irremovability of judges. This law also established some basic financial guarantees for the judges, including state-funded housing and salary increases. Another anticorruption measure was the introduction of computer systems and other tools preventing judges from being able to select which cases they wish to hear, and there are strict penalties for court staff guilty of flagrant procedural irregularities in case assignments.

Public opinion polls continue to indicate low levels of public trust in the judiciary caused by long and inefficient judicial processes and biased decisions. Judicial salaries have improved relative to the average, but are vastly inferior to what litigants can offer when large disputes are at stake.

In practice, computer programs and other measures intended to prevent a party from selecting a certain judge to hear the case can be circumvented by unscrupulous judges and court staff. One commentator suggested that the introduction of the new measures preventing the judges from picking their cases only increased the amount of the bribes. "The only difference is that now you have to wait to see which judge gets your case before offering the bribe." The Moscow arbitration court has dealt with multiple attempts to sabotage such computer systems both by outside hackers and from within its administration.

The judges are swayed, apart from bribery, by political influence, institutional connections, personal relationships, or prominence in one of the parties in the local community. In exchange for favorable treatment, judges can receive preferences in the distribution of administra-

*"Judicial reform [was] carried out in conditions of resource shortages, resistance from conservative forces and the necessity to overcome traditions which practicing lawyers and public opinion have formed during years of totalitarianism."*

—S.A. Pashin judge in Moscow City Court

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BizCLIR, or the Business Climate Legal & Institutional Reform Project, is a multi-year initiative of the United States Agency for International Development with the goal of improving the efficiency and impact of assistance programs intended to help developing countries improve their business enabling environments. This series, Best Practices for the Business Environment, represents one of many knowledge management components of the BizCLIR project. The goal of the series is to highlight the known best practices, case studies, lessons learned, and in some cases worst practices, so that the lessons can benefit other practitioners in the field. All issues are available at [www.bizclir.com](http://www.bizclir.com).

tive and other resources that are under the discretion of local or federal government officials. In a situation of persistent shortages, a possibility of receiving government housing sooner rather than later can be very attractive.

## Enforcement

Until the late 1990s, there was no effective mechanism for the enforcement of judicial decisions in Russia. Entrepreneurs sometimes turned to criminal groups rather than to courts to settle their business conflicts. Such situations perpetuated an atmosphere of lawlessness and the perception of Russia as the new "Wild West."

Federal Laws "On Enforcement Proceedings" and "On Bailiffs," adopted in July 1997, set forth the enforcement procedures for decisions of courts of general jurisdiction and the arbitration courts. These laws gave clarity into the enforcement process and specified the rules of conduct that bailiffs must follow. According to official statistics, as of 2006 only 52 percent of judgments were actually enforced. The courts generally consider complaints against the actions of bailiffs with undue bias for the bailiffs.

In practice, it commonly takes at least two weeks for bailiffs to initiate enforcement proceedings. Then bailiffs send inquiries to the federal tax service, the police, and other agencies regarding the debtor's assets. These agencies take time to comply with the inquiries, which can significantly delay actual collection. Moreover, in some cases, efforts to enforce a valid court judgment can encounter insurmountable obstacles when dealing with other administrative agencies and bureaucracies.

Bailiff offices suffer from a lack of proper facilities and information technology. They do not have access to administrative databases, directories, and other informational resources necessary for the efficient performance of their duties.

## Conclusions

A principal obstacle to any reform is resistance to change from the established system and the people used to working in it. New norms contradict their established mentality, daily routines, and ways to advance one's career. "The problem is not in the procedures, but in the minds of the judges."<sup>1</sup>

There is a low level of awareness of the rule of law among the general population, judges, and government officials. This is combined with the low level of public involvement and a legacy of general distrust by citizens of all authorities, including the judiciary, the police, and the government. "At least one inescapable conclusion is that the legislative reforms are out ahead of the curve. [T]he typical Russian response to legislation that fails to fit societal reality is to ignore the legislation."<sup>2</sup>

In evaluating the impact of the judicial reform on contract enforcement in Russia, it is important to remember that economies in transition have had to adopt procedures and methodologies to enforce concepts that would have been illegal 15 years ago—private property and contractual rights of individuals. The nature of an adversarial system is new, because during Soviet times, both parties to a commercial dispute were commonly both representatives of different state companies. Therefore a concept of the court vs. the parties emerged where the role of the judge was to impose his or her own opinion of what was fair. By contrast, in an adversarial system, it is two parties against each other, and the role of the judge is to be an impartial arbiter.

In addition to obvious ethnic and cultural differences, there is a wide disparity between regions of the Russian Federation in the level of economic and institutional development. This disparity is reflected in the court system as well. The opinion among lawyers in Moscow is that one is more likely to get fair treatment in Moscow or St. Petersburg courts, whereas local courts in other regions are more likely to be swayed by local interests and pressure groups.

<sup>1</sup> William Spiegelberger, Partner, White & Case LLC.

<sup>2</sup> Kathryn Hendley, "Accelerated Procedure in the Russian Arbitrazh Courts," *Problems of Post-Communism*, Vol. 52, No. 6 (November/December 2005), at pp. 21–31.