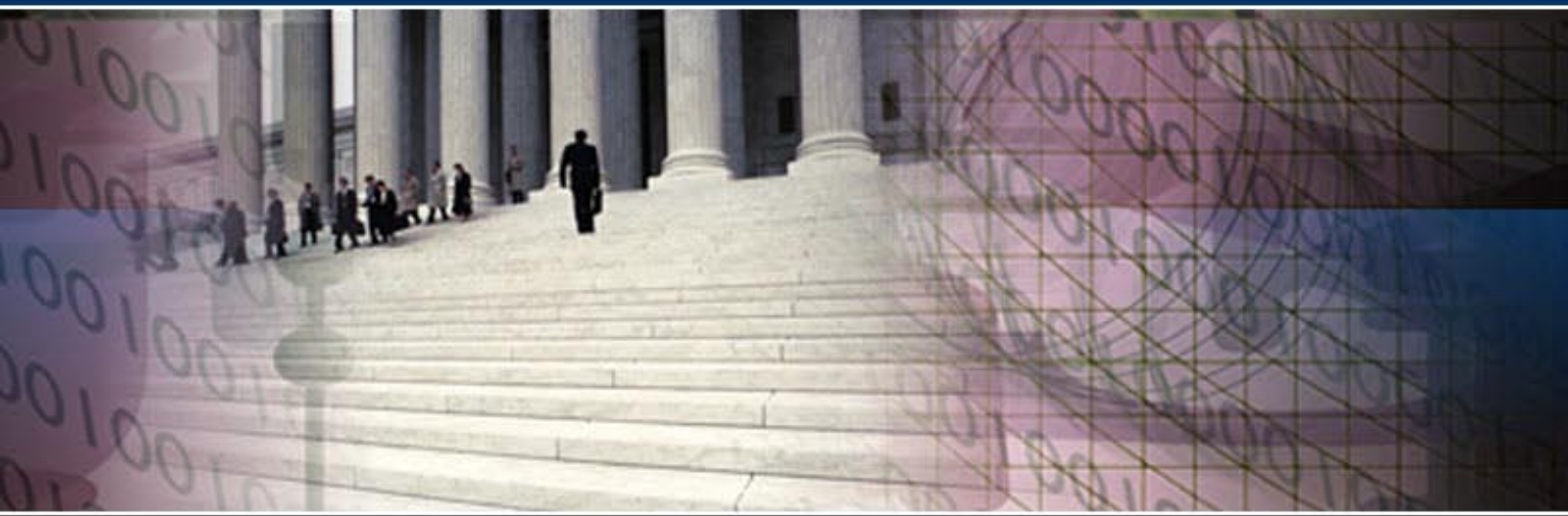
August 2002

Commercial Legal and Institutional Reform (CLIR) Diagnostic Assessment Report for The Republic of Azerbaijan



A USAID Initiative in Developing Countries

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EXECUTIVE SUMMARY

In June 2002, Booz Allen Hamilton conducted a Commercial Legal and Institutional Reform (CLIR) diagnostic analysis of Azerbaijan for the United States Agency for International Development (USAID). The methodology uses a four-dimensional approach covering framework ("black letter") laws, implementing institutions, supporting institutions, and the market for reform of the existing situation. The purpose of the analysis is to provide USAID and its bilateral missions with information and recommendations regarding opportunities for project assistance and reform.

Compared with other countries assessed using the CLIR methodology, Azerbaijan is surprisingly far behind in its transition to a market-oriented legal system that promotes trade, investment, and development. Even making allowance for the difficulties produced by war with Armenia, Azerbaijan has not moved as far beyond its Soviet legacy of command and control systems as other transition countries reviewed over the past few years. Much of the economic capacity of the country has been maintained under the control of the Government or well-connected private sector interests, leaving the average investor (domestic or foreign) in precarious circumstances.

The framework laws, while generally oriented toward the market, are incomplete (lacking detailed regulations) and often confusing due to overlapping legislation that has not been harmonized. On the positive side, many of the laws permit private interests to sue the government agencies responsible for implementation, and an increasing number of lawyers are beginning to take cases against these agencies. In most areas studied, the law is adequate for the time being, but the legislative reform process is not. Lawmaking is not designed to address the needs of the business community, whether for kiosk owners or multinational conglomerates, and there is no formal or dependable information feedback loop. At this time, it is more important to fix the system for making laws than the laws themselves.

Implementing institutions are among the weakest seen in 10 countries studied to date. Courts are held in very low esteem by the public and the legal community. Interviewees raised questions of competency and integrity on a regular basis. On the competency side, however, it should be noted that the commercial law regime has been almost completely rewritten in the past 10 years, with major changes (a new civil procedure code) only 2 years old. Consequently, virtually no one in the legal community is up to date on the law or its application. With no ongoing system in place for continuing legal education or professional training for judges and lawyers, this knowledge gap is unlikely to improve much in the near future.

Other implementing institutions, such as property and company registries, are also problematic. The land registries are functioning sufficiently well for now, but there is no institution for registration of ownership or claims against movable property. The company registry is in substantial need of reform to ensure timeliness and transparency in providing services.

During this assessment, one of the most consistent themes arising in connection with government institutions was corruption. Private citizens almost unanimously complained of unofficial payments, inappropriate audits and assessments, and other rent-seeking behavior. This was compounded by a fear of complaining publicly and openly, so that there is little formal protest or lobbying for change. The sense of intimidation expressed has translated into the assessment team's decision to attach no contact names to this report. Normally, the team would provide an annex of interviews, but the respondents were concerned enough about consequences of being associated with "complaints" that the team promised complete anonymity.

The lack of supporting institutions was surprising. Most transition and developing countries have a much deeper layer of nongovernmental organizations, professional associations, business associations, and other interest groups developing and finding their way in civil society. These groups are generally either weak or nonexistent in Azerbaijan. This appears to be another legacy of the Soviet years, in which any organization existed only at the behest of the government. Other countries have begun to overcome that legacy through support for organizations, or at least a laissez-faire attitude that permits such development. In Azerbaijan, even many professionals are reluctant to form associations that might catch the Government's attention, and a number of respondents suggested that some government agencies are opposed to the formation of professional groups. Without the development of supporting institutions, little self-sustaining, meaningful change is likely, suggesting that this is one of the most important areas on which to focus project assistance.

In light of the foregoing, it is not surprising that the market for reform is dysfunctional. On the demand side, disenfranchised investors (the majority of the investment community) clearly see the need for change but do not have the organizational mechanisms or strategic vision for pursuing it. In addition, they must compete with deeply entrenched interests who actively oppose reforms, such as open competition, and have access to the corridors and levers of power. On the supply side, there are few local professionals with the experience and background to craft the legislative and implementation reforms needed, and they must compete with the entrenched government interests who profit from the lack of change.

In conclusion, there is much work that can and should be done to improve the commercial environment. Most of the short- and medium-term needs are at the foundational level to build for the future through improved supporting institutions, legislative process, and clarification of commercial rights. Simply changing laws or assisting implementing institutions is unlikely to achieve significant impact at this time.

I. INTRODUCTION

At the request of the United States Agency for International Development Mission in Baku, Azerbaijan (USAID/Baku), Booz Allen Hamilton (Booz Allen) has undertaken a Commercial Legal and Institutional Reform (CLIR) assessment of the Republic of Azerbaijan.

A. THE AZERBAIJAN ASSESSMENT

The purpose of the CLIR assessment was to assist the USAID/Baku in its strategic planning so that programmatic resources could be focused on high priority needs for additional legal and institutional reform work in Azerbaijan. In addition, the team sought to identify potential counterparts among public and private sector stakeholders.

This assessment was performed from June 15 to 29, 2002, by a team of nine expatriate specialists. The team members and their areas of specialization are presented in the following table:

NAME	ORGANIZATION	CLIR SPECIALTY
Wade Channell, *Team Leader*	Booz Allen, Legal Reform Specialist	Real Property
Emad Tinawi	Booz Allen, Legal Reform Specialist	Foreign Direct Investment, Trade
Christopher Williams	Booz Allen, Registry Specialist	Registries, Logistics
Judge Michael Williamson	Federal Bankruptcy Court	Bankruptcy
Claudia Dumas	USAID/E&E, Legal Reform Specialist	Collateral (Secured Transactions)
Joseph Murrie	USAID/E&E, Legal Reform Specialist	Competition
Anita Ramasastry	University of Washington School of Law, Comparative Law Specialist	Commercial Dispute Resolution
Donald Clarke	University of Washington School of Law, Comparative Law Specialist	Contract
Tom Jersild	Independent Consultant	Company

The assessment was performed in two parts. First, prior to departure, the team reviewed the laws, regulations, and related literature, relying heavily on work by the University of Washington School of Law, with assistance in updating from USAID/Baku, the American Bar Association/Central and East European Law Initiative (ABA/CEELI) in Baku, and various local counterparts. Second, in Azerbaijan the team interviewed numerous government officials, nongovernmental organizations, multilateral and bilateral donor agencies, judges, lawyers, notaries, investors, and other businesspeople to assess the commercial legal environment of Azerbaijan. (The assessment team has not attached a list of contacts out of respect for privacy of the interviewees.)

B. BACKGROUND TO THE DIAGNOSTIC METHODOLOGY USED

This assessment is the 11th in a series of assessments carried out since 1998 in a program created by USAID in which Booz Allen was retained to assist in the development of indicators and methodologies for assessing the status of CLIR in a developing or transition country.

The first four assessments — Kazakhstan, Poland, Romania, and Ukraine — were used to devise, refine, and field-test the methodology. The methodology and results were then subjected to peer review by approximately 50 legal development professionals at a workshop in Prague during December 1999. On the whole, the participants verified and affirmed both the methodology and results through a reality check based on their professional experience in the European and Eurasian regions. Moreover, they provided important input on the indicators used for scoring the countries. Based on this feedback, the indicators were revised during the winter of 2000.

The new indicators (CLIR 2.0) have been used to conduct diagnostic assessments for Albania, Armenia, Bulgaria, Croatia, Macedonia, and Serbia. In addition, two new areas have been developed. Real property was tested in Armenia, Bulgaria, and Azerbaijan, and commercial dispute resolution was tested in Azerbaijan.

C. NOTES ON SCOPE AND METHODOLOGY

The diagnostic assessment was designed to help USAID missions achieve the following objectives:

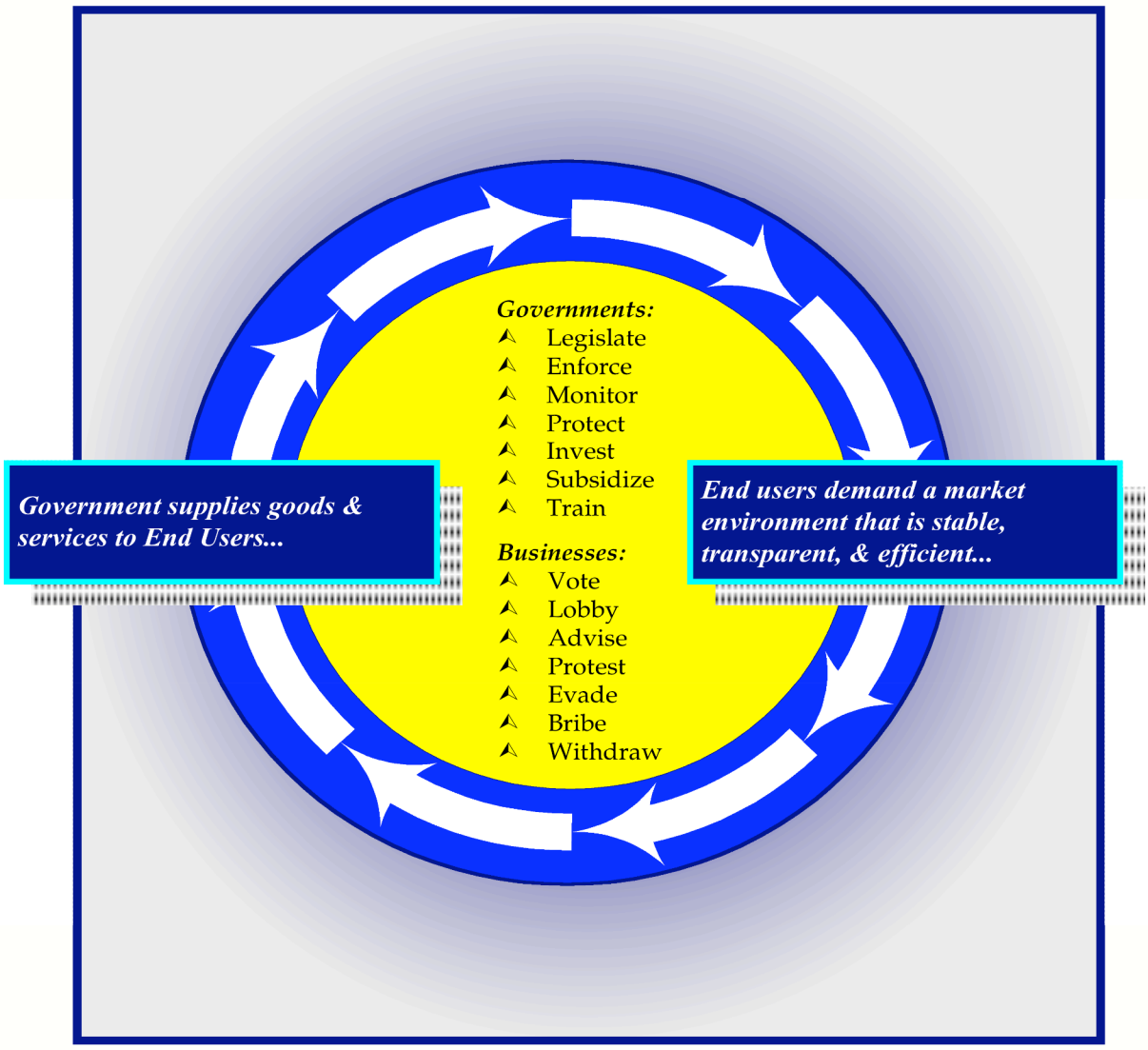
- To provide a factual basis for characterizing the degree of development and the status of commercial law reforms in a country
- To provide a methodologically consistent foundation for identifying and describing the root causes of the "implementation/enforcement" gap
- To provide analytical and planning tools and metrics that will help USAID design new approaches to sustainable, cost-effective CLIR interventions.

For the purposes of most assessments, "commercial law" is defined to include the following substantive legal areas:

- **Bankruptcy.** Mechanisms intended to facilitate orderly market exit, liquidation of outstanding financial claims on assets, and rehabilitation of insolvent debtors
- **Collateral.** Laws, procedures, and institutions designed to facilitate commerce by promoting transparency, predictability, and simplicity in creating, identifying, and extinguishing security interests in assets

- **Commercial Dispute Resolution.** Laws, procedures, and institutions relating to the settlement of commercial disputes, whether through courts or alternative dispute resolution mechanisms, and the enforcement of judgments and decrees
- **Companies.** Legal regimes for market entry and operation that define norms for organization of formal commercial activities conducted by two or more individuals
- **Competition.** Rules, policies, and supporting institutions intended to help promote and protect open, fair, and economically efficient competition in the market, and for the market
- **Contract.** The legal regime and institutional framework for the creation, interpretation, and enforcement of commercial obligations between one or more parties

IS THERE A MARKET FOR COMMERCIAL LAW REFORM IN AZERBAIJAN?



- **Foreign Direct Investment (FDI).** The laws, procedures, and institutions that regulate the treatment of FDI
- **Real Property.** The laws, procedures, and institutions responsible for establishing, maintaining, and preserving rights in real property, including land, buildings, easements, liens, and other interests in real property

- **Trade.** The laws, procedures, and institutions governing cross-border sale of goods and services.

Within each of these substantive areas, four dimensions of CLIR were examined as a conceptual framework for comparison. These include the following:

- **Framework Laws.** Basic legal documents that define and regulate the substantive rights, duties, and obligations of affected parties and provide the organizational mandate for implementing institutions (e.g., Law on Bankruptcy, Law on Pledge of Movable Property)
- **Implementing Institutions.** Governmental, quasi-governmental, or private institutions in which primary legal mandate to implement, administer, interpret, or enforce framework laws is vested (e.g., bankruptcy court, collateral registry)
- **Supporting Institutions.** Governmental, quasi-governmental, or private institutions that either support or facilitate the implementation, administration, interpretation, or enforcement of framework laws (e.g., bankruptcy trustees, notaries)
- **Market For CLIR.** The interplay of stakeholder interests within a given society, jurisdiction, or group that, in aggregate, exert an influence over the substance, pace, or direction of commercial law reform.

II. BROAD FINDINGS AND CROSSCUTTING THEMES

As mentioned previously, Booz Allen conducted a diagnostic assessment of the commercial legal and institutional environment of the Republic of Azerbaijan in June 2002. In addition to analysis of the nine specific areas of law, the Mission expressed a need for identification of short-term opportunities with potential impact and potential government and private sector counterparts. These interests relate to the recent waiver of Section 907 of the United States Freedom Support Act, which was waived in 2002, thus opening the opportunity for USAID to work directly with the Government. The waiver will be reviewed in January 2003, at which point it could theoretically be revoked. Consequently, there was a short-term window of opportunity to engage the Government in reform. These interests of the Mission are addressed in the Executive Summary and elsewhere in the report, in the normal law-by-law analysis of the commercial environment. In addition, the report includes a separate section of crosscutting findings that affected two or more areas of law in order to capture common areas of concern and to avoid redundancy.

A. OVERVIEW

Azerbaijan achieved independence in 1991 with the collapse of the former Soviet Union. The joy of this accomplishment was soon tempered, however, by war with Armenia over disputed territory in the Nogorno-Karabakh region, with open fighting between the countries through 1995. Only in the past 6 or 7 years has the country been able to concentrate on the mundane business of becoming a country. As a result, the systems examined are still quite young, as becomes apparent throughout the analysis.

Azerbaijan's economy can be usefully divided into two sectors: (1) oil and gas, and (2) everything else. The oil and gas sector is growing well, accounting for virtually all of Azerbaijan's 10 percent annual gross domestic product (GDP) growth over the last several years. The sector also accounts for more than 90 percent of government revenues and is completely dominated by foreign investment from multinational oil companies.

The nonoil sector can again be divided into another two sections: (1) Baku, and (2) the rest of the country. Baku, officially home to one million people and perhaps unofficially home to more than two million, is the primary beneficiary of foreign investment. It is a large, relatively clean, relatively modern port city benefiting from trade and some industrial investment. It also houses the local headquarters of the various oil investors and their expatriate staff.

The rural economy receives little if any foreign investment, and domestic investment tends to be small scale and uneven. Once a net exporter of foods to the Soviet Union, Azerbaijan has become a net importer and has even set up some barriers to imports to protect at least some

aspects of its flailing food industry. Overall, the nonoil economy has been accurately described as "moribund."

While it is tempting to excuse the weak economy as simply the result of war and the inexperience of a nascent Government learning its way, this is not sufficient. These factors certainly underlie some part of the economic woes, but the greater problems lie in institutional factors such as corruption, official predation, and a legal system that is ineffective in enforcing contracts or protecting investments. Any business that is successful, the team was told, is either forced to take on a government agency or official as a "partner," fight for its right to exist without such interests, or else shut down. The lesson of the goose that laid the golden eggs does not appear to have resonance here.

The success of the oil and gas sector has actually retarded the growth of the nonoil sector instead of enhancing it, because the Government's limited institutional capacity is focused on oil and gas, and the revenues from that sector make reform in the non-oil sector less pressing. There is apparently a large underground economy, and it is estimated that anywhere from $10 million to $50 million a month is remitted back to the country from the Azeri Diaspora. (The team was told that there were more than 20 million Azeris in Iran, for example, but this number may depend on how "Azeri" is defined.)

The pervasive corruption has resulted in a society with virtually no middle class. More than 60 percent of the population falls below the poverty line. The existing middle class is concentrated primarily in Baku but is under constant economic pressure. There are numerous anecdotal reports of entrepreneurs fleeing from the formal to the informal sector at an alarming rate. In short, the investment climate is just not healthy.

This ill health is not a result of poor laws, but of poor implementation. The overall legal framework is properly oriented, with general guarantees of the rights normally sought by investors. Changes are needed in many areas, but implementation of even these existing laws would lead to substantial improvement in the commercial climate.

Implementation problems result in part from inexperience, but the major complaint is one of corruption. Although verification of actual instances was beyond the scope of the assessment, the assessment team was constantly and repeatedly told of instances of corruption at every interface between the public and private sector. This included both the demand for bribes and the abuse of influence to improperly affect the outcome of an administrative or judicial decision. There were even reports of donor-funded projects being cancelled or delayed because of officials demanding personal payments. This theme is picked up in most of the sections of this report because of the pervasive negative impact.

B. SUMMARY BY INVESTOR CONCERNS

The purpose of the CLIR diagnostic methodology is to assist USAID missions in their mandate to enhance economic growth and development, which occur through trade and investment. To ensure that this assessment is not simply a lawyers' view of how to improve legislation, the team has also attempted to capture an investor perspective on how the different aspects of the CLIR environment might affect investment decisions.

The team begins by recognizing that the primary purpose of investment is profits. Whether a farm laborer who decides to invest time toiling in the sun instead of other productive or non-productive activities or the multinational investing land, labor, and capital in a large venture, decisions (absent compulsion) are based in great part on the likelihood of return on that investment. Return on investment is a function of three factors: revenues, costs, and risks. The commercial legal environment affects each.

1. Risk

In Azerbaijan, the risk factors are quite high. Investors noted that the rapidly changing legal framework left them uncertain about the rules of the game and hesitant to increase their investments or make strategic moves because new laws might change the results without warning. Although it is perfectly reasonable for Azerbaijan to make extensive legislative changes as it replaces laws inherited from the Soviet Union with market-oriented laws, the method of change can be structured to minimize risk and surprises.

The legislative process in Azerbaijan increases the level of risk. Laws are passed without notice, without comment, and without public knowledge of who is behind them or why they are being passed. All countries require ongoing legislative change, but mature democracies include the stakeholders in the process of change to support formulation of laws responsive to business needs, to create the support necessary to ensure implementation, and to allow the commercial sector to prepare for eventual changes, whether positive or negative. The fact that commercial interests in Azerbaijan uniformly stated that they do not know what the law will be tomorrow is a sign that dramatic change is needed if the Government wants economic development.

Risk is also very high because of the distorting effects of corruption. Random tax audits, demands for early payment of taxes, unforeseeable problems with registration or licensing, and lawsuits decided by patronage all raise the risk of increased costs and decreased revenues sales, which must be managed effectively for business success. High-risk investors manage this risk in part through requiring higher rates of return, which results in higher consumer prices, or in

reducing or eliminating their activities until the situation improves. All of these problems are seen in Azerbaijan.

2. Costs

Like risk, costs are also affected by corruption. Initial and ongoing bribes raise the cost of doing business. This results in increased prices, or if there is strong price competition, the added burden can cause the enterprise to become unprofitable and collapse. Numerous respondents commented on the number of small vendors in Baku who set up kiosks or small stores for various products, only to fail within a few months despite reasonable sales because of illegal payments demanded by government officials. There is also universal frustration with the tax authorities, with reports of rampant demands for bribes, enforced by threats of tax audits accompanied by exorbitant "findings" of arrears. Interestingly, the situation has become so bad that the often-reticent local business community is beginning to sue the tax authorities in Economic Court, and it is reported that they are winning some of the cases.

Unnecessary delays in registration increase startup and other costs of companies by delaying their ability to engage in commerce. Numerous respondents noted the poor execution and anti-competitive misuse of registration procedures by those responsible for various business registrations. These delays tie up resources invested in an enterprise pending commencement of operations, or hinder the ability of a company to respond to a changing market, causing them to lose potential revenues or even market share.

Excessive licensing is another source of costs. There are reported to be more than 400 license categories, with businesses requiring separate licenses, sometimes from separate agencies, for related activities such as jam and juice production. Cost of compliance can be considerable, especially for smaller enterprises, but there is also a cost in time and flexibility in responding to changing market demands. If a company sees an opportunity and needs a new license to pursue it, the opportunity may be lost or compromised by the time the license is granted, especially if there are licensing delays resulting from incompetence or corruption.

Moreover, delays in imports and exports occasioned by arbitrary and capricious exercise of authority by government officials adds to the costs of many companies in Azerbaijan.

3. Revenues

Revenues are a function of market size, in terms of population and buying power. At present, the buying power of most Azeris is rather limited, but this is a commercial risk that investors can manage. Likewise, the population is relatively static (aside from movement of internally displaced persons), growing at fairly predictable rates, and can be factored into decisionmaking.

The assessment team identified several negative revenue factors that government reforms could eliminate. First, there are a number of de facto monopolies and cartels strangling the revenue stream in potentially lucrative industries, such as cotton and hazelnuts. Producers are often forced to sell at depressed prices to monopoly buyers. With their revenues limited, they do not reinvest proceeds at the rate they would if there were competition for the products. This is depressing overall investment in entire industries that could be contributing considerably to economic growth and development.

Corruption also acts as a revenue drain by reducing market access. The team heard reports of illegal tampering with import and export rights of domestic and foreign investors, compromising their ability to compete in domestic and export markets and affecting their revenue flows.

The net impact of these problems in costs, risks, and revenues is that the commercial environment is very unhealthy. Some larger companies can absorb the cost of excess licensing, or limit the number of bribes paid, but smaller ones cannot. In fact, anecdotal evidence given to the team was that a number of investors were leaving at every level of the economy: two international banks have closed because of profitability problems, more than 150 Turkish investors left last year, and thousands of wage earners and farmers are reported to be emigrating to Russia and elsewhere in the region to get paying jobs. The CLIR environment is in need of substantial change.

C. SUMMARY BY DIMENSION AND CROSSCUTTING THEMES

1. Legal Framework

As already noted, the framework laws are generally oriented in the right policy direction but are often vague, contradictory, and insufficient in terms of detail. The legal framework can better be described as a legal shell for most areas of commercial law. Although laws of general principles exist, most of the needed implementing regulations do not yet exist, leaving great gaps in interpretation and implementation. In other instances, such as company law, there are large gaps in the overall framework, although what does exist is acceptably drafted. Legal professionals also complain that there is insufficient commentary available on the laws, other than Russian commentaries on similar laws from other jurisdictions.

The greatest concern at the framework level, however, is not the laws themselves, but the process by which they are made. A donor organization could conceivably provide technical assistance, create a draft, and then persuade the Government to adopt it. Because of gaps in process, a competing interest could exert similar pressure a year later and undo any perceived benefits from new legislation. The process, therefore, is just as important as the end result.

At present, laws are passed without any mandatory public review. The private sector is invited to comment on an ad hoc basis, depending on the predilections of those in charge of drafting. There is little if any public information on the Government's legislative agenda (whether in the executive or legislative branch) other than through personal connections. Enactment of new laws is often a surprise to the general legal profession and business community. Although there are exceptions to these generalities, that is precisely the problem: proper lawmaking is an exception.

2. Implementing Institutions

Azerbaijan has created most of the implementing institutions required for each area of law, but on the whole, they are all very weak. Problems cited by users and noted by the assessment team include insufficient knowledge and experience with the subject matter, insufficient funding, lack of authority to fulfill their mandates, and systemic corruption. The lack of knowledge is to be expected because of the vast quantity of changes taking place in the past few years and can be addressed through training and education; other weaknesses will be harder to overcome.

The courts received the lowest score given of the 10 countries assessed by Booz Allen since 1998.[1] This reflects the unanimous negative ratings given by the business and legal communities on court performance.

The problems with the courts can be summarized as competence and corruption. While there is a very high perception of corruption, it is probably overstated. A number of respondents reported successful use of the courts to obtain judgments based on law, but only after ongoing, concerted pressure. In addition, there is a tendency to suspect foul play when few or none of the parties understand or know the law, and the written opinions - if produced - are of low quality, both of which are true in Azerbaijan.

Competence issues arise from the lack of education in new laws, the lack of training in the role and responsibilities of judges, and the lack of a system for ensuring accountability. In 2000, all judges were terminated and required to reapply for the jobs, based in part on a written test for all candidates. Although 40 percent of the sitting judges were replaced, 100 percent were ignorant of the new Civil Code, which was just being passed. Indeed, there is very little knowledge of the body of new laws on the bench.

Corruption cannot be dismissed as a mere perception. The universal complaints regarding the courts and other implementing institutions, including interview respondents who can quote prices and dates as well as examples of influence-based decisionmaking, make it clear that there is a

[1]Courts have been scored as the implementing institution for contracts. The 10 scores to date are: Albania (51%), Armenia (41%), Azerbaijan (39%), Bulgaria (61%), Kazakhstan (66%), Macedonia (62%), Poland (83%), Serbia (63%), Romania (73%), and Ukraine (49%).

serious problem with rule of law issues. Confidence in the courts of Azerbaijan is abysmally low, and there is not yet any system of alternative dispute resolution to replace it.

3. Supporting Institutions

Azerbaijan is unique among countries assessed so far for the absence of supporting institutions. It is natural that the development of such institutions would be slow for historical reasons, but countries with similar backgrounds are ahead of Azerbaijan. In Azerbaijan, people generally do not take a controversial public stand, whether individually or as the member of an association. Instead, they seem to embody the behavior inherent in the Japanese proverb: "The nail that sticks up gets hammered down."

Reasons given for the underperformance in this dimension focused on the slow pace of change in government. At independence, Azerbaijan moved from a unit of the Soviet Union, with history of planned economy and command politics, to an independent republic with the same characteristics. There was no history of either democracy or capitalism to draw from, and unlike its neighbor Armenia, Azerbaijan does not have a strong Western Diaspora to influence change. Today, there is evidence that the transformation from subject to citizen is beginning, at least in Baku, but the habits learned from decades under the KGB will be slow to change until the Government openly advocates and welcomes dissent, and prosecutes cases of abuse of power.

This general observation is punctuated, however, by the presence of several promising institutions, suggesting that there may be more in the wings that could be formed with encouragement and foreign donor support. (This support may be more psychological than financial - several respondents felt strongly that foreign-supported associations had greater capacity to resist inappropriate use of power by government officials.)

4. Market for Reform

The demand for change in the private sector is undermined by deeply entrenched private sector interests who are reported to benefit substantially from patronage and an interlinking of political and economic interests. Very strong connected firms work effectively against reform to their privileges, working behind the scenes to keep from opening competition or reducing methods for manipulating the system. Reform is further undermined by complicity of the private sector in continuing the historical system of competition through bribery. The Soviet legacy, of which Azerbaijan is an heir, has been described as a system of formalized corruption, which has skewed expectations and incentivized nontransparent behavior. Professionals, bankers, judges, and others have been implicated in a complex system of bribery and influence peddling that seems to pervade the overall system. While certainly not all are guilty, it is also true that many do not see any ethical, moral, or economic basis for condemning or changing this behavior.

Despite these compromises, there is a strong desire for change throughout the disenfranchised private sector. This desire is often too diffuse and unfocused to rise to the level of demand. There are few outlets for capturing and articulating the frustrations expressed regarding the lack of supporting institutions. Indeed, civil society in Azerbaijan is comparatively underdeveloped. Few institutions are actively or effectively seeking reforms in the commercial environment.

The supply side of the equation is not any better. Although the Government has provided a number of market-oriented reforms in recent years, the quality of the legislation is limited and the process of lawmaking is deeply flawed. Implementation is beset by problems of insufficient capacity and institutionalized corruption, including recognized resistance to change in some ministries and agencies. In many areas, the political will for reform is not yet strong enough to overcome this entrenched resistance. It was widely believed that part of the problem is ignorance of the negative economic impact of the existing structures and behaviors, but education will not be enough to overcome the personal incentives associated with rent-seeking behavior. Reform will require very strong leadership and enforcement of disincentives.

D. SUMMARY BY AREA OF LAW

1. Bankruptcy

The existing law is adequate for the immediate and short-term needs of the country. Only six or seven cases have been brought under this law to date, and all but one of those was for the liquidation of financial institutions. A project is already under way to create a separate legal regime for insolvency of financial institutions, so there is essentially no pressure on the system for normal bankruptcy cases.

This low-level usage of the bankruptcy law reflects the absence of commercial credit. Bankruptcy is a system for restructuring or cleaning up bad debt, so that without commercial debt, there is little need for bankruptcy. Liquidation aspects of the law may be useful for elimination of defunct state enterprises and disposal of assets, but these do not overcome the political concerns and social consequences related to termination of employees. Until there is more lending, there is no need to expend donor resources on the bankruptcy system.

2. Collateral and Real Property (Secured Transactions)

Although these two areas of law are discussed separately in great detail, the issues can be summarized together. The legal framework for property rights and secured lending is a patchwork of related laws that were drafted without sufficient harmonization between the potentially conflicting parts. As a result, there is a property rights regime sufficient for most

transactions but compromised by gaps and confusion. The legal framework would benefit greatly from a project to harmonize the existing laws.

The area of property rights was the only one in which there were any gender issues identified. Abuses in the area of real property transfers related to fraud by husbands who forged the signature of their wives to sell property without permission, only to have the transactions undone when the wife discovered and protested the sale. The problem, however, is not in the law so much as the practice. The law requires that both spouses consent to the sale of real property in which both have an interest. In practice, husbands often present a release from the wife, instead of having the wife present as an equal partner at the transaction before the notary. A responsive market should result in a change in practice, not in law, with buyers requiring the physical presence of both parties to protect themselves from fraud.

The implementing institutions reflect the patchwork legal framework. There are several separate registries for various property transactions, with land, buildings, privatized state holdings, and vehicles all registered in separate places. Unfortunately, there is no registry at all for interests in movable property other than automobiles, leaving a tremendous gap in the overall secured transactions system. Unregistered pledges are legally invalid, so that currently no system exists for validating pledge interests in movable property other than automobiles. The Ministry of Justice is reported to be tasked with the responsibility of creating such a new registry for movable property, and perhaps harmonizing existing registries. There is confusion, however, over what types of property will be covered by what registry. For real estate (land and buildings), the registration system is currently adequate for the demand, but not for the accelerated growth needed by Azerbaijan. As demand grows, the system will need to be improved.

Notary services are a mixed blessing in the area of secured property rights. On the one hand, the existing cartel structure (the number of notaries is limited by law) has led to general certainty in the passage of good title because notaries tend to have jurisdiction over all transactions within a given geographical area, especially as regards real property. Because their legal responsibility for passing good title (which has been enforced in several lawsuits), notaries currently act as gatekeepers and provide stability in the system.

Cartels have a tendency to drive down the quality of service over time while raising prices. In Azerbaijan, there are interesting and positive developments to combat this. First, the provision of notary services, currently a government function, is being privatized with the creation of private notary services. Second, the notaries have recently had their fee structure lowered substantially at the behest of the banking industry, so that fees are generally considered reasonable by the users, even when unofficial fees (often equal to official fees) are added to the cost. A core group of notaries within the Ministry of Justice is interested in reform of the system

and establishment of registries, having identified this time as historically pivotal for ensuring a proper foundation for future development.

Demand for reform is focused on the need for a pledge registry for movable property, to the extent there is focused demand. Overall demand is diluted by the poor health of the lending sector, whose profitability is hampered by high transaction costs and high risks, especially the risk of unenforceable contracts in the event of nonpayment. Perhaps more important, existing local banks tend to be poorly capitalized, and focus their lending activity on historical patrons and connected interests rather than competing for new business or developing new products. The situation is worse than similar problems in other post-Soviet countries studied due to the high costs and risks of banking, which have led to the departure of two international banks in recent months. With the right system in place, sellers, leasing companies, and nonbanking financial institutions can practice secured lending on their own, so the need for a pledge registry is even greater as an alternative to traditional, ineffective banking.

The supply capacity is probably sufficient, with limited technical assistance needed. Other registries are functioning reasonably well in terms of organization and basic services provided, and there is reason to believe that the Government could provide the same in a movable property registry. Technical assistance is needed to ensure a market-oriented, lender-protective system, especially in light of misunderstanding of the purpose of registry embodied in the law. (Registration is required by law for a pledge agreement to be enforceable; the better approach would be that the agreement should be enforceable with or without registration, which is used to perfect a lender's interest in the property against other claimants.)

3. Commercial Dispute Resolution

The lack of a dependable system for commercial dispute resolution is one of the unifying themes for all other areas of law covered under this assessment. The legal framework provides on paper for a theoretically adequate judicial system, especially with the recent establishment of Economic (commercial) Courts to handle commercial disputes among entities and entrepreneurs, but the courts in general are not functioning effectively. The laws do not yet provide for any recognized system of domestic alternative dispute resolution (ADR), however, but neither do they forbid it. As a result, there are several projects under way to establish some form of ADR.

The courts are perceived to have low competence and high corruption. Respondents repeatedly and consistently cited problems of bribery and political influence, known as telephone justice, as undermining respect for the judiciary. Problems with competence are to some extent understandable because of the legislative upheaval in the past 4 or 5 years in which much of the Soviet legal system has been replaced or overlaid with more market-friendly laws, and no formal training in these laws has taken place. The confusion engendered by ignorance of the law (including ignorance by the parties and their lawyers) creates both the perception of corruption,

when judges do not write meaningful decisions to explain their reasoning, and the opportunity for corruption because it is difficult to ascertain whether the decision comports with the law.

Whatever the actual level of corruption, the lack of any known system of discipline, ethics, or accountability for judges further undermines the judges' credibility and competence. The use of telephone justice - in which a government official tells a judge how to decide a case - is perceived as a serious problem also. Establishing any confidence in the judiciary will be a steep, uphill struggle requiring high-profile reformers and high-profile reforms. At this time, there is no indication that any reform efforts are being developed or advocated by the Government or the judiciary itself.

The supporting institutions for commercial dispute resolution are also weak. First, the bailiffs who are responsible for enforcing decisions are not well organized or trained. Second, there has been no association of judges that could serve as a basis for training the judiciary or examining and pursuing the need for reform. An association of Economic Court judges was being formed at the time of the assessment and will be important to follow. It is rumored that the Ministry of Justice is opposed to the formation of a judges association out of opposition to any independent, unified voice within the judiciary. (Whether this is true could not be confirmed, but the rumor is evidence of the low esteem in which the Ministry is held by the legal profession.) Third, bar associations or other lawyers' groups are still nascent and do not yet have significant strength to push for reforms. ABA/CEELI is providing some needed support in the area of legal research, and legal clinics in partnership with Azerbaijan University Law Faculty, but independent provision of such services has not yet developed.

Demand for reform is universal, but unfocused. This can be seen in part from the efforts by the American Chamber of Commerce for Azerbaijan (AmCham) and the Azerbaijan Association of Entrepreneurs (with support from the Eurasia Foundation) to create an independent ADR system. Indeed, the support for these programs and comments from numerous respondents indicates that the business community has in great part given up on the courts and is trying to replace them with an alternate judicial system rather than reform the existing judiciary. It also indicates that there is little confidence that the Government can supply the needed changes.

4. Company

The legal framework for company law is characterized by appropriate but insufficient provisions. The law is generally sound, as far as it goes, but it does not go far enough. The Securities Committee is currently drafting a new law to address some of these gaps, including issues of corporate governance, but this draft is also inadequate, despite outside technical assistance. Further assistance is needed.

The implementing institution - the Company Registry - is undercutting the otherwise positive environment for company law. The Registry is notorious for unnecessary delays in registration, sometimes taking months to register a company. There are widespread complaints of rent-seeking and abuse of authority for political reasons, including delays based on political and religious discrimination. The additional costs of these delays can be absorbed by larger investors, but not by smaller entrepreneurs who are significantly damaged by their inability to do business or who cannot handle the elevated costs of entering the formal sector. The company registry is responsible, in part, for the increased choice of small businesses to avoid the formal sector and operate in the gray economy.

At this time there are very few supporting institutions at all for company law issues.

Demand for change in the registration and licensing system is quite high, and the AmCham and the Association of Entrepreneurs are actively pursuing reforms. Changes in the law, however, are being pursued from the supply side. The State Securities Commission is heading the reform of the company law and is very open to additional technical assistance to ensure the best possible result. Unfortunately, this Commission is not involved in the issue of licensing reform, which does not yet have a champion on the supply side.

5. Competition

The area of competition law is one of the least developed of the nine areas studied. The law itself has the proper orientation but is poorly drafted and insufficient. The Competition Agency charged with implementing the law is only a shell of an institution with insufficient funding and insufficient staffing to fulfill its mandate.

Supporting institutions for competition law are also weak. Although there is some statistical capacity within the Government and within the private sector, there does not seem to be any group focused on or trained in economic statistics related to analyzing anticompetitive behavior. Complaints of monopolies and cartels abound and are captured in part by the AmCham, but there is no significant association to voice the concerns of the agricultural sector, which is deeply affected by export and import cartels.

Demand is not only diffuse, it is effectively counterbalanced by entrenched interests who influence the Government. The de facto monopolies are known to be politically connected and rumored to use their connections extremely effectively to suppress competition and concentrate market share in their own hands. If the Competition Agency is any evidence, there appears to be very little political will to create an environment in which competition can flourish, at least within the economically significant sectors of the economy.

6. Contract

The legal framework for contract law is in flux. A newly adopted Civil Code procedure provides a wide range of modern, European provisions defining the rights and obligations of parties to contract, but the new Civil Code is virtually unknown. As in many other areas of Azeri law, the contract provisions of the law would be adequate if implemented, but they are not.

The failure of the courts to settle disputes according to law has already been noted and need not be repeated here. It is worth noting, however, that consistent enforcement helps to teach and refine understanding of the law among the business community, so that the failure of the courts has a ripple effect in undermining an otherwise adequate legal framework.

Notaries are another implementing institution for contracts in many former Soviet states, and Azerbaijan is no exception. The notaries are adequate for the current demands, especially in light of the changes under way (privatization and reduction of fees). They could readily serve as a principle counterpart for education on the new Civil Code, but first need training in the new laws themselves.

Few supporting institutions focus on contract law issues, other than the law schools. Azerbaijan University has updated its curriculum to address the new Civil Code, and it is hoped that Baku State is doing the same. (This was not confirmed.) In any event, these schools have the capacity, with some technical assistance desired, to upgrade understanding of the new laws among new lawyers, and possibly to provide continuing legal education services to existing lawyers.

Demand for change in contract law tends to be a function of the complexity of the contracts employed in the commercial sector. Most of Azerbaijan's economy operates on a cash basis, with little sophisticated lending or other complex transactions taking place. Consequently, demand is appropriately low. For now, there is little need to reform the law, but great need to educate the legal community about the existing law.

Foreign Direct Investment

The legal regime for foreign investment contains important protections for foreigners and would be generally adequate for the present if it could only be enforced. Unfortunately, the law is undercut by implementation problems, making Azerbaijan relatively unattractive as a destination for foreign investment.

The Foreign Investment Agency is quite weak. Although charged with assisting investors and promoting investment, it cannot overcome the entrenched interests in other agencies that are damaging the investment climate. Foreign (and domestic) investors complain vigorously about

excessive licensing requirements and delays in company registrations, the Foreign Investment Agency has proven highly ineffective at combating these problems. Problems of systemic corruption and ineffective dispute resolution, repeatedly noted elsewhere, also have a strong negative impact on the investment environment.

The only supporting institution pushing for the interests of foreign investors is the AmCham, and it is not enough. In well-developed civil societies, domestic investor groups lobby for improvements to the overall investment climate, which creates conditions attractive to foreigners. (Protectionist interests of these groups are counterbalanced, in part, by competing foreign investor associations.) In Azerbaijan, these groups do not yet have a voice, to the extent they even exist.

The demand for change is not met by the capacity or willingness to provide it. Much of the foreign investment policy and practice is focused on the large interests - oil companies and large multinationals - who can cut their own deals. Changes to the investment climate that would attract smaller foreign investors (such as the Turkish investors who are reported currently to be disinvesting) and domestic investors do not seem to be high on the official reform agenda.

8. Trade

The framework laws for trade are well oriented and bolstered by numerous bilateral treaties and regional trading arrangements. Azerbaijan is keenly interested in World Trade Organization (WTO) membership (driven by the perceived need to accede before Armenia can enter and possibly block membership) and is attempting to meet the various legal and regulatory requirements for membership. Unfortunately, these laws, even if perfected, are not enough because the real issue for trade with Azerbaijan can be found in the numerous nontariff barriers supported by entrenched interests.

The Ministry of Economic Development (MOED) has a trade unit staffed with young, energetic professionals dedicated to achieving WTO accession and open to technical assistance. They are not, however, capable of battling the other government agencies responsible for maintaining trade barriers. The Customs Service is widely perceived as both inefficient and corrupt, where it is possible for monopoly interests to influence enforcement and compliance in order to prejudice competitors and limit uncontrolled trade. The licensing authorities for the more than 400 activities requiring licenses are also a target of constant complaint by all sectors of the foreign and domestic commercial community. There is no existing unit or agency able to challenge these interests or otherwise promote an open trade regime in a meaningful manner. Supporting institutions, other than AmCham, are virtually nonexistent.

The market for reform is characterized by high demand from the foreign community, limited understanding of the issues by the Azeri community, and deeply entrenched interests opposed to

reform. Desire for WTO membership may help to bring about some reforms, but there is little to indicate that Azerbaijan, if accepted, would move quickly to ensure compliance with WTO obligations and standards.

E. KEY OPPORTUNITIES AND COUNTERPARTS

Opportunities for meaningful assistance require a combination of demand for change and counterparts interested in pursuing reforms and capable of producing them in the current climate. Azerbaijan lacks a deep supply of counterparts, suggesting that one of the greatest needs is project assistance in developing more associations who can act as counterparts. This seems especially true for the rural and agricultural sector, where there are even fewer effective associations to represent the interests of this large, impoverished population.

Where counterparts already exist, much of the reform need is for long-term project assistance on a number of fronts. Because of the possibility that the 907 waiver could be revoked (restricting USAID's ability to provide much assistance to the Government of Azerbaijan) during a long-term project, the team focused on shorter-term initiatives with potential for impact. There are several significant opportunities there.

1. Company Law

The State Securities Committee has already begun a process of reforming the existing framework for company law. They have received outside technical assistance to add a few new provisions - mostly regarding corporate governance - but significant gaps in the law remain. Momentum within the Government is significant, so that the Committee could ensure passage of their draft, even with the existing weaknesses. Short-term technical assistance could be employed effectively to correct the deficiencies now rather than later, after yet another defective law has been passed.

This opportunity is two-fold. First, it is possible to ensure that the new law includes numerous missing provisions required by international best practices. Second, this is an opportunity to work with a drafting group to employ a more democratic, deliberative process. A consultant working with the Committee can do more than just provide drafting assistance. The consultant can help them take the draft to the business community for discussion, comment, and revision to ensure that the private sector actually supports and takes ownership of the new law. This increases the possibility of effective implementation.

It is unlikely that the current lawmaking system will be responsive to a direct attempt to change the lawmaking process based on principles of democracy, governance, and rule of law. It is possible, however, to demonstrate such processes as a model for future endeavors.

Counterparts include a significant government counterpart, the State Securities Commission, and private sector organizations such as AmCham and the Association of Entrepreneurs.

2. Property Rights Regime

Like company law, work on property rights presents a multifaceted opportunity.

First, the numerous overlapping laws have created confusion that can be greatly reduced simply by analyzing the existing regime, clearly separating real, movable, and intangible property issues, and harmonizing the laws. This can be done in thorough systematic explanation of the laws to the extent they function properly, including explanation of the various registries and how they fit into the system. This explanation could take the form of both written, permanent articles and brochures for use by registries, notaries, courts, bankers, realtors and lawyers, and training programs for the legal community. It may also require legal changes, which presents an opportunity to work with local drafters to train them in harmonization, consistency and drafting techniques, and in interactive, democratic systems of lawmaking.

Potential counterparts for this work include the Chamber of Notaries (under the Ministry of Commerce), the MOED, the bar associations, law schools, and realtors. The ABA should also be engaged to reduce resistance, but they may not yet qualify as a supportive counterpart. There may also be a ready counterpart within the Parliament; the assessment team was told that the Parliament has a legal reform agenda and active interest in reform, but was unable to meet with any representatives to establish the nature and level of interest.

Additional projects could include assistance to realtors in improving the availability of market information (listing services) for Baku and the interior and work with notaries in standardizing forms and practices for property transactions (including movable property transactions). In addition, registry clerks have noted that few people do an acceptable job in preparing documents for registration, including completing forms properly. In other countries, backlogs and delays have been reduced by creating information brochures for the public and training programs for professionals dealing with the registries.

The most glaring gap in the current regime is in the registries. Existing real property registries do not need to be reformed in the short term; they are serving the market adequately. As mentioned previously however, there is tremendous need for a movable property registry to support the growth of commercial transactions, especially in agriculture, as a basis for creating a meaningful collateral lending system. The movable property registry simply does not exist but

could be built (assuming political consensus) within a year using lessons already learned by USAID in Albania, Macedonia, Armenia, and elsewhere. The initial registry does not even have to be computerized, although that is desirable, as long is it is readily accessible. Additional assistance would be necessary to support the implementation and sustainability of the registry, including education of lenders, borrowers, lawyers, and judges and a public education campaign to create awareness of the new commercial opportunities.

Counterparts include the Ministry of Justice, which may be problematic and which is reported to be tasked with creating a new registry for movable property, the Chamber of Notaries, National Bank of Azerbaijan, and the ABA.

3. Alternative Dispute Resolution

The Eurasia Foundation is currently providing some assistance in arbitration, but there is an opportunity nonetheless to expand the impact of its assistance through joint efforts in organizing a new system and training a wide variety of stakeholders. The demand for some form of respectable, reputable dispute resolution system is immense. Counterparts would be primarily, if not exclusively, from the private sector. This opportunity should be discussed carefully with the Eurasia Foundation as a first step.

4. Public Education Commercial Rights

One of the obstacles to proper enforcement of existing laws is ignorance of the law by implementing institutions and private sector stakeholders. Although it exercises a degree of self-censorship, the press of Azerbaijan is surprisingly open about reform needs and would likely be very interested in assisting to correct deficiencies through public education. Likewise, there is at least one very capable public relations and marketing firm that could provide local technical expertise in structuring such programs.

Specific programs, based on demand for reform by the private sector, should target company registration and tax audits. Although this would not have the immediate effect of changing practices by the government institutions, it would lay the foundation for public pressure for change. A "Know Your Rights" campaign would enable many private sector interests to resist abuse of authority by the tax service and insist on better service by the Company Registry.

Counterparts could include the Company Registry (at least for input on registration requirements), media, the Young Lawyers Association, law schools, the AmCham, Association of Entrepreneurs, local marketing firms, and consumers' organizations.

5. Assistance with the Foreign Investment Advisory Service (FIAS) Red Tape Analysis

The World Bank, under the Foreign Investment Advisory Service (FIAS) is just completing a roadmap or constraints analysis regarding bureaucratic impediments to investment. These types of studies are extremely useful in identifying and cataloging unnecessary constraints in the investment environment. In the team's experience, however, these studies must be adopted as an action plan through an on-the-ground project of assistance, or they become nothing more than intellectual exercises filed away forever on a ministry bookshelf.

The study was in the process of completion during the assessment. The assessment team cannot, therefore, comment on the contents or findings but can assume that the results will provide the basis for practical interventions.

The counterparts would include the MOED, a number of affected agencies, lawyers associations, and the business community.

6. Business Constraints Analysis and Action Plan

The FIAS study mentioned above will note problems in the system, but it will not identify the priorities or needs of the business community based on their plans and actions. In addition, it will address only bureaucratic constraints.

In the team's experience, some of the most effective legal reform work flows out of work with the business community in identifying the constraints most important to them, preferably in open venues with invited government representatives. It is worth considering such a project for Azerbaijan, although modified to take into account general reticence for public complaint by using individual surveys to obtain the priorities, then allowing the consultants to present the results, thus protecting the identity of those complaining. The presentation should be made in an open forum, which groups such as the AmCham would support. The goal of the workshop would be a public/private sector reform agenda, endorsed by the Government.

Counterparts would include the MOED, the Ministry of Finance, the business community, agricultural organizations, and the legal profession.

7. Preliminary Steps to Competition through Farmers Associations

Tree crops, particularly hazelnuts, are one of the most important cash crops and revenue earners in the agricultural sector. Production has fallen since Soviet times, and the rate of investment today is heavily suppressed by the export cartel in this commodity. It may not be possible to take on the cartel in the near term, but it is possible to build the foundation for that struggle while

improving economic performance by working with associations (including creation of associations) to train farmers in improved crop maintenance, harvesting, and shipping techniques. Introduction of improved pruning and maintenance will produce immediate results in terms of tree productivity, while associations with valuable services to offer are being created. This will in turn create credibility for the associations to speak on behalf of producers in combating the ill effects of export monopolies.

The team recognizes that this is not a normal commercial law project, but the team is pragmatic. It is unlikely that the law and practices can be changed quickly, but the foundation for change can be built while also producing directly measurable economic benefits for the poorest segment of the Azeri population.

8. Other

Other recommendations for change appear elsewhere in the report. Most recommendations entail long-term efforts to direct and support reforms. All of these efforts, however, should include work through private sector associations and local service providers to strengthen them, and work with government agencies to introduce them to the private sector for feedback.

III. REVIEW AND ANALYSIS BY AREA OF LAW

A. BANKRUPTCY

1. Overview

The Law of the Azerbaijan Republic on Insolvency and Bankruptcy (Bankruptcy Law) appears to provide an adequate legal framework for dealing with insolvency and bankruptcy cases. However, the Bankruptcy Law, which was approved by the Milli Mejlis (the Parliament) on June 13, 1997, has rarely been used.

This is a result of two factors. First, the laws and courts dealing with commercial and consumer credit are generally viewed as inadequate by lenders. In this regard, there is a general perception in the business and banking community that the key implementing institution, the court system, is not effective - specifically, the system is perceived as slow, expensive, and not impartial in its resolution of civil disputes. Just as important, an efficient central registry system for recording of liens on collateral has yet to be developed. Accordingly, there is little commercial or consumer credit available in the country, leading to rare application of its Bankruptcy Law. Second, there is a lack of education among the practicing lawyers and the judiciary about the availability and application of the Bankruptcy Law.

As a result, in the years since the Bankruptcy Law's enactment there have been approximately 6 or 7 business cases and no individual bankruptcy cases filed. Consequently, there are also no organized bankruptcy bar associations or other supporting institutions - such as accountants and workout consultants experienced with the Bankruptcy Law's operation.

There will be no market for institutional changes or assistance in the area of insolvency and bankruptcy laws until the institutional problems with the court system are solved, an efficient collateral registry created, and commercial/consumer credit becomes readily available.

2. Legal Framework

a. Liquidation

Bankruptcy cases may be filed either voluntarily by a debtor or involuntarily by one or more creditors of the debtor (Art. 2, ¶ 5) (all citations to "Art." and "¶" are to the Bankruptcy Law). Individuals and legal entities (referred to as "enterprise-debtors") operating in the country are eligible for bankruptcy relief with the exception of public organizations not engaged in commercial activity and not-for-profit organizations (Art. 2, ¶ 2). Banks and other credit organizations are also eligible for bankruptcy (Art. 2, ¶ 2). In fact, the majority of cases that have been filed involved debtors that were financial institutions. There is currently under

consideration the need to remove the liquidation of banking organizations from bankruptcy jurisdiction and deal with them administratively (in a fashion similar to that in which insolvent banks are dealt with in the United States).

For a bankruptcy case to proceed, either voluntarily or involuntarily, the debtor must be insolvent (Art. 3). A debtor is recognized as insolvent if the debtor admits to insolvency or if the court finds that the debtor is insolvent. The Bankruptcy Law contains one of the traditional definitions of insolvency by defining insolvency as the debtor's inability to pay its debts when they become due (Art. 3, ¶ (c)). In addition, the Bankruptcy Law definition of insolvency includes the debtor's failure to pay a debt to a single creditor within 2 months after demand by the creditor (Art. 3, ¶ (a)).

A debtor can commence a bankruptcy case by the filing of a petition in the trial court (Art. 4, ¶ 1), and, in the case of an enterprise-debtor, the debtor can also initiate a bankruptcy case without the initial involvement of the court (Art. 2, ¶ 6; Art. 4). One or more creditors can also initiate an involuntary bankruptcy case by filing a bankruptcy petition in the court (Art. 2, ¶ 6; Art. 6, ¶ 1).

The date of the petition for bankruptcy is considered the "moment of bankruptcy" and is substantially analogous to the petition of bankruptcy under the U.S. system in defining what constitutes the "property of the debtor" (Art. 1 [definition of "moment of bankruptcy" and "property of debtor"]; Art. 2, ¶ 5), and in prohibiting the debtor from disposing of any property without permission of the bankruptcy administrator or court order with the exception of payment of current wages of employees, current expenses of operation, and as necessary to protect the assets of the debtor (Art. 17, ¶ 1 and 2).

After the filing of the case in the court, the party filing the case must publish an announcement about the filing and a notice of the time of the hearing to consider the petition, in the official newspaper twice in two successive weeks at least 7 days before the court hearing date to consider the petition (Art. 9, ¶ 1). At the hearing to consider the petition, the court will make a ruling regarding the debtor's insolvency and eligibility for bankruptcy (Art. 11, ¶ 1(a)).

If the debtor is adjudicated bankrupt, an administrator will be appointed. The rights and responsibilities of an administrator are similar to those of a trustee under the U.S. bankruptcy laws (Art. 19 and 20). If the court determines that the debtor is not insolvent or otherwise eligible for bankruptcy, the court may award compensation for damages incurred by a party as a result of the improper filing (Art. 11).

After the debtor has been adjudicated bankrupt, the administrator will schedule a meeting of creditors to be held not later than 1 month from the court's ruling (Art. 13, ¶ 1). The administrator must provide notice by mail of the meeting to all known creditors not later than 14

days before the meeting and publish the notice twice in the official newspaper not later than 7 days before the meeting (Art. 13, ¶ 2).

As an alternative to filing a voluntary petition, an enterprise-debtor may initiate a bankruptcy case without the involvement of the court (Art. 14). Upon making such a decision, the debtor retains a qualified person to act as a provisional administrator subject to approval by the creditors (Art. 16, ¶ 2(b)). The debtor must schedule and provide at least 14 days notice to creditors of the meeting of creditors to be held not later than 21 days from the date of the decision to institute the bankruptcy case (Art. 15, ¶ 1, 2). In addition, the debtor must publish the notice of the bankruptcy and creditors' meeting twice in the official newspaper at least 7 days before the meeting of creditors (Art. 15, ¶ 2(b)).

At the initial meeting of creditors, the enterprise-debtor must confirm its decision to institute the bankruptcy case. The act of confirming this decision at the meeting of creditors is legally equivalent to the court's adjudication of bankruptcy in an involuntary case and is considered the "moment of bankruptcy" for purposes of the Bankruptcy Law (Art. 16, ¶ 2(a); Art. 18, ¶ 1(b)). The creditors must also either approve the debtor's choice of proposed administrator or elect someone of their choice (Art. 16, ¶ 2(b)). In addition, the creditors may elect a creditors' committee at the meeting (Art. 16, ¶ 2(c)).

The "moment of bankruptcy" automatically imposes a stay of any action against the debtor (Art. 18, ¶ 2(a)). Claims against the debtor can be made only through the claims process of the bankruptcy case (Art. 18, ¶ 2(b)). Enforcement of judgments is stayed (Art. 18, ¶ 2(c)). The authority of the manager of an enterprise-debtor is terminated, except to the extent authorized by the administrator (Art. 18, ¶ 2(d)).

Upon the occurrence of the "moment of bankruptcy" and the appointment of the administrator (which takes place at the time of the court adjudication at the hearing held in a case initiated in the courts [Art. 11, ¶ 1(a); Art. 18, ¶ 1], or at the meeting of creditors in a case initiated without court involvement, [Art. 16, ¶ 2; Art. 18, ¶ 1(b)], the administrator becomes the sole legal representative of the debtor (Art. 20, ¶ 1). Immediately after the administrator's appointment, the administrator is required to publish two announcements about the debtor's bankruptcy and the administrator's appointment in the official newspaper.

The administrator is required to perform the same sort of functions performed by trustees under U.S. bankruptcy law. Specifically, the administrator must take control of the debtor's property, (Art. 21, ¶ (a)), take measures to sell the property, (*id.*, ¶ (h)), reject executory contracts, (Art. 20, ¶ 4(b)), object to claims, (Art. 21, ¶ (j)), collect debts due the debtor, (*id.* , ¶ (k)), obtain approval of compromises reached with creditors, (*id.* , ¶ (l)), review and pursue as appropriate actions against insiders, (*id.* , ¶ (m)), make interim distributions to creditors holding claims, (Art. 20, ¶ 4(e)), and such other actions that are consistent with his other duties under the Bankruptcy Law

(*Id.* ¶ (r)). In the process of liquidating the debtor's assets, the administrator also has the right to carry on the business of the debtor, (*id.*, ¶ 4(a)), hire and terminate employees, (*id.*, ¶ 4(h)), and retain professionals, (*id.*, ¶ 4(i)).

Sales of the debtor's assets are generally to be conducted through public auctions (Art. 25, ¶ 1). However, the administrator has wide latitude to sell by means other than auctions where there is an immediate need to sell the assets in some other fashion, or if in the professional judgment of the administrator, such other method of sale will be in the interest of creditors (Art. 26, ¶ (a)(f)).

The notice of the meeting of creditors (which is provided in court cases by the administrator (Art. 13, ¶ 1), and by the debtor in cases filed by enterprise-debtors without court involvement (Art. 15, ¶ 1) must inform creditors that they must file claims within 60 days from the date of publication of notification of the bankruptcy (Art. 43, ¶ 1). Properly filed claims are then examined within 30 days of their filing by the administrator, who must either accept or reject the claim and inform the creditor in writing of the administrator's decision (Art. 45, ¶ 2). If the creditor does not agree with the administrator's determination, the creditor may request a court hearing within 21 days of receipt of the administrator's objection to the claim (Art. 45, ¶ 3). Within 28 days after expiration of the 60-day period for filing of claims, the administrator must prepare a schedule of claims setting forth whether the claim has been accepted or rejected, the sum of accepted claims, and the priority of each claim. This schedule is filed with the court within 7 days after its preparation for consideration and approval as appropriate (Art. 46, ¶ 2).

The administrator is required to give notice to secured creditors of the initiation of the bankruptcy proceeding. Although court proceedings directed to obtaining a money judgment against the debtor are stayed at the "moment of bankruptcy," (Art. 18, ¶ 2(a)), secured creditors may nevertheless still pursue their rights directly against their collateral (Art. 47, ¶ 1). However, if the secured creditor does not act to pursue its collateral within 14 days after receiving the notice of the bankruptcy from the administrator, the administrator has the right to sell the collateral, pay off the secured claim less sales costs, and retain the balance for the benefit of the other creditors (Art. 47, ¶ 2). In the event that the sale proceeds are insufficient to pay off the secured creditor's claim in full, the secured creditor may file a claim for its unsecured deficiency (Art. 47, ¶ 8).

Claims of unsecured creditors are satisfied in order of their priority (Art. 52, ¶ 2). Claims of equal priority are paid pro rata (Art. 52, ¶ 3). The priority of payment is as follows:

First Priority - Administrative Claims. All cost of administering the bankruptcy case including fees and expenses of the administrator, the administrator's legal expenses, and claims incurred by the administrator to third parties after the "moment of bankruptcy" are entitled to first priority in payment (Art. 53, ¶ 1(a)).

Second Priority - Employee Personal Injury Claims. Claims of employees arising from bodily injury or death occurring during working hours are entitled to second priority in payment (Art. 53, ¶ 1(b)).

Third Priority - Employee Wage and Benefit Claims. Claims of employees arising from wages and other benefits incurred within 6 months before the moment of bankruptcy are entitled to third priority in payment (Art. 53, ¶ 1(c)).

Fourth Priority - State and Local Tax Claims and Credit Organization Claims. Two distinct types of claims are entitled to fourth priority in payment: (1) taxes and deductions for state social insurance owed to state or local governmental entities and incurred within 1 year prior to the moment of bankruptcy, and (2) credit organization claims arising from banking activity with the debtor (Art. 53, ¶ 1(d)). In effect, claims of general unsecured creditors are subordinated to claims of institutional lenders.

Fifth Priority - Unsecured Claims. Claims of unsecured creditors are entitled to fifth priority in payment (Art. 53, ¶ 1(e)).

Sixth Priority - Owners of the Enterprise-Debtor. Claims of the owners of the enterprise-debtor are entitled to sixth priority in payment (Art. 53, ¶ 1(f)).

Any surplus after distribution to claimants as described below is paid to the debtor.

The administrator has the right to pursue certain transfers that occurred prior to the moment of the institution of the bankruptcy case. Specifically, the administrator may avoid transfers by the debtor of property or a pledge of property if the following two elements are present: (1) the debtor was insolvent at the time of the transfer, and (2) the transfer was made within 90 days in the case of noninsiders, and 1 year in the case of insiders from the moment of institution of the bankruptcy case (Art. 55). If the court finds that a transfer is avoidable, the court may (1) direct that the property transferred be returned to the debtor, (2) cancel any security provided to the creditor by the debtor, (3) enter a money judgment against the creditor, (4) order that any guarantor whose liability was satisfied by the transfer is still liable for the debt owed, (5) assess the director of the debtor for losses resulting from such transfer, and (6) enter such other orders as are appropriate under the circumstances (Art. 56, ¶ 2(a)-(f)).

The Bankruptcy Law imposes liability on directors of the enterprise-debtor under certain circumstances. Specifically, directors are required to be knowledgeable about the debtor's economic activity and, based on that knowledge, take such actions as necessary to protect creditors from losses (Art. 57, ¶ 1). In evaluating a director's liability for breach of this obligation to creditors, the court must take into account the director's actual experience and qualifications (subjective standard) as well as the experience and qualifications that would

normally be expected of persons occupying the position of a director (objective test) (Art. 57, ¶ 2).

Directors are required to initiate bankruptcy cases at the moment the director learns about the insolvency of the debtor (Art. 57, ¶ 3). However, a director is also liable if the enterprise-debtor files a bankruptcy at a time that it is not insolvent (Art. 59). Likewise, a director is liable if the enterprise-debtor is made insolvent deliberately (Art. 59).

Directors found to be in breach (of the obligation to file bankruptcy when the enterprise-debtor is insolvent) are liable in an amount equal to the losses incurred by creditors as a result of the failure to file. However, there is a "safe harbor" available to directors faced with the insolvency of the enterprise-debtor. A director is not liable for the failure to file if (1) the director did not know about the activities resulting in the extra losses to the debtor, (2) the director was given false information by management about these activities, or (3) the director objected to the activities upon learning about them and submitted a resignation as director if such activities continued after the director's objection (Art. 58).

The Bankruptcy Law provides for a discharge of a debtor's debts to the extent not paid from the proceeds of the liquidation of the debtor's assets. Claims of creditors that remain unpaid because of a lack of assets are regarded as annulled except in cases where the claim arose from deliberate or fraudulent actions of the debtor (Art. 53, ¶ 8). In the case of individual debtors, there is a separate provision providing that all debts that existed before the bankruptcy are regarded as fully paid, except claims arising from the individual debtor's obligations for alimony or child support (Art. 60, ¶ 4).

b. Reorganization - "Amicable Settlement with Creditors"

The Bankruptcy Law contains two alternatives to liquidation. The first is an "amicable settlement with creditors" provided for under Chapter VII. This procedure is somewhat analogous to a chapter 11 reorganization under U.S. bankruptcy laws. The second is a sanation provided for under Chapter VIII of the Bankruptcy Law.

The debtor may propose an "amicable settlement with creditors" after the commencement of the bankruptcy case (Art. 35, ¶ 1). In cases instituted with the involvement of the court, the administrator must consider the feasibility of any such proposal and inform the creditors and the court whether the proposed agreement is in the interest of creditors (Art. 21, ¶(g); Art. 35, ¶ 3).

The Bankruptcy Law is flexible with respect to the contents of the debtor's proposed agreement with the creditors. The form of agreement may provide for the reorganization of the enterprise-debtor's business, sale of all or part of the debtor's business, and payment of all or part of the claims of unsecured creditors in a lump sum or in installments (Art. 36, ¶ 1(a)-(d)). Prior to its

consideration at a meeting of creditors, the proposed agreement must be sent to all creditors together with financial information including a balance sheet and list of creditors and the amounts they are due.

Creditors must be provided a notice of the date, time, and place of the meeting of creditors at which the proposed agreement will be considered for approval (Art. 36, ¶ 2). The meeting of creditors must be held no earlier than 14 days and no later than 28 days from the date that the creditors are provided the proposed plan, the financial information concerning the debtor, and the notice of the meeting (Art. 36, ¶ 3).

At the meeting, the creditors may vote to either accept the proposed agreement, reject the agreement, or accept the agreement with modifications as long as the agreement, as modified, does not vary significantly from the agreement that was provided to creditors with the notice of the meeting (Art. 36, ¶ 5 and 6). If, in the opinion of the administrator, any modifications to the agreement proposed at the meeting do result in the agreement differing significantly from the one previously provided to creditors, then another meeting must be called to consider the proposed agreement as modified (Art. 36, ¶ 6).

The decisions of the creditors concerning acceptance of the proposed plan are made according to the rules governing voting procedures at creditors' meetings generally (Art. 36, ¶ 7). Under these rules, a quorum exists if the creditors represented at the meeting hold not less than 50 percent of the total amount of the unsecured claims. The agreement must be approved by a majority of creditors attending the meeting who must hold the majority of claims of creditors represented at the meeting. Alternatively, if a majority in number of creditors does not support the proposed action at the meeting, the proposed action will be approved if creditors holding at least 75 percent of the amount of the debt that is held by creditors represented at the meeting.

No later than 7 days after a creditors' meeting at which a proposed agreement with creditors is approved, the administrator must submit the proposed agreement to the court for approval (Art. 37, ¶ 1 and 2). Any creditor who objects to the proposed agreement may appear and be heard at the hearing to consider approval of the proposed agreement (Art. 37, ¶ 3). Upon approval by the court, the proposed agreement becomes binding on all creditors to include creditors that voted against the agreement and creditors that did not attend the meeting of creditors (Art. 37, ¶ 6) (with the exception of secured creditors, and holders of administrative claims and priority employee-related claims who must consent to the extent their claims are affected by the agreement [Art. 38, ¶ 1]).

c. Sanation

The other alternative to liquidation is a process called "sanation." While there is no equivalent word in the English language in common usage, the Latin root of sanation is *sanare,* which

means "to cure." In fact, under the Bankruptcy Law, sanation is the process in which all liabilities of the debtor are fulfilled (Art. 40, ¶ 1).

The process of sanation is initiated by a debtor in a pending bankruptcy by filing a petition with the court requesting a stay of the bankruptcy case while the court is considering the option of sanation (Art. 40, ¶ 3). To obtain approval of the sanation proposal, the debtor must satisfy the court that the debtor and its owners or other third party can feasibly pay one-third of the claims of creditors within 12 months of approval of the sanation with the balance payable within 24 months (Art. 40, ¶ 2, 3, and 6). During the process of sanation, the stay of any attempts to enforce prebankruptcy claims remains in effect (with the exception of secured creditors whose agreement must be obtained if their rights are to be affected) (Art. 40, ¶ 9 and 10).

d. Bankruptcy Law in Practice

Although the Bankruptcy Law has been available for dealing with insolvent debtors for several years, its use is virtually unknown to the banking and business community. Indeed, in discussions with local attorneys practicing in Baku as well as court officials familiar with its use, it appears to have been first used in 2000 and since then in only 6 or 7 business cases. Of these cases, 5 or 6 involved banks and credit organizations and one a manufacturing company.

In all of these cases, the object of the bankruptcy case was the liquidation of the debtor's assets as opposed to reorganization. While the Bankruptcy Law does contain provisions under which a reorganization can take place through an "amicable settlement with creditors" or through the process of curing debts through a sanation, it does not appear that either of these two processes has ever been employed in practice. Thus, reorganization of a debtor rather than liquidation is not currently considered a practical alternative under the Bankruptcy Law as practiced in Azerbaijan.

It is also noteworthy that the majority of cases that have been filed have involved financial institutions. In many other countries, banking institutions are excluded from liquidation under the bankruptcy laws because alternate provision is made for their liquidation under various regulatory laws. In this regard, it appears that there is a draft of legislation under consideration that would amend the Bankruptcy Law to exclude banks from eligibility for relief under the Bankruptcy Law in favor of an appropriate regulatory agency.

In addition, although the law does contain a provision that provides that at the conclusion of a bankruptcy involving an individual debtor, all debts that existed before the bankruptcy are regarded as fully paid (with the exception of alimony and child support), there have been no personal bankruptcy cases filed to date under the Bankruptcy Law. The general view of those attorneys familiar with its use in practice is that an individual consumer case is simply not an available alternative to a consumer not engaged in business as an entrepreneur.

It appears that the major factor causing such infrequent use of the law is the general lack of commercial or consumer credit. The absence of credit results principally from two factors. First, as discussed in detail in the section of this report dealing with the courts and commercial dispute resolution, there is a general perception that the court system is not effective in enforcing parties' rights, thus lenders are wary of the high risk of nonpayment if they cannot effectively enforce their loans. Second, as discussed in detail in the section of this report dealing with collateral, there is no effective and efficient central collateral registry to ensure priority of claims in the event of nonpayment, creating an even higher risk the loans cannot be enforced or satisfied from secured assets. Thus, there is virtually no secured lending in the country. Bankruptcy is primarily a legal system for dealing with commercial debt, so until there is significant commercial lending, there will be little need for bankruptcy.

3. Implementing Institutions

Under the Civil Code, bankruptcy cases must be filed in the economic trial courts. There are no specialized courts specifically dealing with bankruptcy cases. Indeed, the current volume of bankruptcy cases does not justify such a separate court. This lack of a specialized court combined with a general perception that judges suffer from a lack of training particularly in the areas of law dealing with commercial disputes does, however, impact the use of the bankruptcy laws. As bankruptcy filings increase, this lack of training and understanding of the underlying commercial laws that affect debtor-creditor relations in insolvencies will become more pronounced and problematic.

Further, the general lack of confidence by the business and banking community in the court system as a speedy, cost-effective, and impartial forum in which to resolve commercial disputes also affects the use of the Bankruptcy Law to liquidate or reorganize insolvent debtors as well. To give creditors the perception that they can benefit from participating in bankruptcy cases, further judicial reform will need to be accomplished. As stated by one business person, "There is no legal system." This perception will need to change before an effective bankruptcy system can effectively deal with insolvent debtors. Experience elsewhere suggests that specific technical assistance programs in bankruptcy should await increased demand for the services.

4. Supporting Institutions

Because the bankruptcy system has yet to develop as a viable tool in dealing with insolvent debtors, there is a general absence of supporting institutions with respect to the Bankruptcy Laws. Such supporting institutions would include individuals who regularly serve as administrators, accountants specializing in the insolvency areas, workout consultants, appraisers of financially distressed businesses and properties, and bar associations dedicated to the

promotion and enhancement of insolvency professionals. None of these institutions currently exist in Azerbaijan.

In addition, there are no voluntary judges' organizations dealing specifically with bankruptcy. However, recently an Economic Court Judges Association was formed. Presumably, this organization will be in a position to facilitate the education of judges in the areas of creditors' rights and bankruptcy as the use of the Bankruptcy Law increases.

The few supporting institutions that do exist are not focused on this area of law. Investor groups such as AmCham or the Association of Entrepreneurs are concerned with more basic areas affecting the investment environment, not bankruptcy. Even the ABA is not working in this area, being more concerned with liquidation of a number of defunct banks and with basic issues of enforcement of commercial obligations.

5. Market for Bankruptcy Law Reform

Until credit is significantly more available, there will be no market for reform. That is, the Bankruptcy Law seems to have effectively dealt with the liquidation of the few cases that have been filed. While more widespread use of the law may highlight deficiencies that will result in a demand for improvement, no current demand for revisions to the law currently exists.

Certainly, there is a need to reform the legal system generally. This is an area that affects all aspects of Azerbaijani society. Obviously, the practice of Bankruptcy Law will benefit from institutional judicial reform. However, the demand in the area of effective enforcement of contractual rights completely overshadows any needs specific to the prosecution of a bankruptcy case. That is, although the manner in which creditors and debtors are treated under a given bankruptcy system influences the extent to which lenders are willing to extend credit and to commence bankruptcy proceedings in the event the enterprise-debtor fails, Azerbaijan's needs for institutional reform exist at a much more fundamental level.

Simply put, until the problems with effective enforcement of contractual obligations and a viable collateral registry system are corrected, there will be very little lending. There is correspondingly little need for bankruptcy reform in a country where the absence of lending makes bankruptcy relief unnecessary, and indeed, irrelevant to the country's business community. Indeed, most of the cases that have been filed involve financial institutions. These entities typically have as their major creditor constituency individual depositors. Individual depositors are not lenders in any traditional sense.

The concept of business failure and laws dealing with insolvency and bankruptcy are very new to Azerbaijan. While the Bankruptcy Law enacted in 1997 appears to provide an effective

framework for the liquidation or reorganization of financially distressed debtors, in practice it has had little application.

Until the environment for commercial and consumer lending matures to the point where commercial and consumer credit are widely available, bankruptcy laws will be little used. Accordingly, there is no current demand for institutional reform in the narrow area of insolvency and bankruptcy laws. Indeed, if there were any needs in this area, they would be insignificant when compared to the larger needs for judicial reform and the establishment of an effective collateral registry system.

B. COLLATERAL LAW

> "At first, you think you're okay if you have a security interest. But, then you go to the courts and things are not okay."
>
> *Businessperson from Baku*

1. Overview

In a mature economy with strong legal rights that are enforced by the justice sector, secured creditors can enforce loans efficiently when debtors become unable to repay credit. This certainty and efficiency leads to wider credit availability, lower credit terms, and longer maturities. Azerbaijan, however, currently lacks the legal and institutional infrastructure for growth of secured lending.

Donors are uniform in their consensus that for Azerbaijan to achieve sustainable economic growth and reduce poverty, the country must diversify its economy beyond the oil and petrochemical sector. Small and medium agribusinesses will require credit to procure the seed, equipment, and plants for Azerbaijan to move beyond individual subsistence agriculture. Non-agricultural small, medium, and large businesses will require credit to support real estate construction and improvements, to finance certain operating costs, and to purchase equipment and inventory. Individual consumers may also benefit from financing to purchase new consumer goods, such as vehicles. Meeting these needs will require substantial change.

The legislative framework governing collateral in Azerbaijan is fragmented, confused, and incomplete. Although a recently enacted Civil Code does provide a post-Soviet starting point for approaching property rights and pledges of collateral, the absence of a clear, complete, and consistent framework creates uncertainty in practice, whether attempting to create a security interest in movable property or trying to enforce that interest in the courts.

Azerbaijan's establishment of a rationalized collateral registry system is a necessary institution to support the extension of secured credit. Azerbaijan lacks a collateral registry system by which creditors can establish a nonpossessory interest in collateral. Several registries are presently maintained by other governmental bodies for various types of collateral. However, these registries do not cover all types of collateral, such as equipment, inventory, and accounts receivable. There is confusion regarding the breadth of assets they are intended to cover. In some cases, their authority under the Civil Code is unclear.

Azerbaijan also requires a judicial system, including a bailiff service, that enforces court decisions, so that the rights of a secured creditor to obtain and foreclose on collateral can be efficiently and consistently enforced. The timely, clear, and predictable enforcement of

creditors' rights would increase lending institutions' willingness to extend credit. The fact that enforcement would occur on a timely basis would serve two purposes. It would provide the creditor with assurances that debt would in fact be protected by collateral and also would reduce the likelihood that borrowers would voluntarily default. Information regarding attempts to foreclose on real property collateral establishes that creditors who attempt to enforce their mortgage interests frequently encounter a judicial system where delays are common, judges do not uniformly apply the law, and numerous appeals are taken by creditors and debtors. When a creditor ultimately obtains a final decision in its favor, the creditor starts an uphill battle once again in pursuing enforcement of that decision. Those charged with executing the decisions are perceived by a wide section of the population as expecting bribes, acting slowly if at all, and commonly supporting sweetheart dispositions under which the sales prices are artificially low.

2. Legal Framework

The Civil Code, which became effective in September 2001 and was passed in connection with Azerbaijan's application to be admitted to the Council of Europe, provides the starting place for analyzing secured lending in Azerbaijan. Prior to the Civil Code, the more detailed 1998 Law on Mortgage governed pledges of collateral.[2] The 1998 Law on Mortgage may supplement and expand the Civil Code to the extent it does not conflict with the provisions of the Civil Code. The Civil Code provides for possessory pledges of collateral as well as for nonpossessory pledges. The main provisions of the Civil Code that govern pledges of collateral, including Articles 307 through 323, do not distinguish between real property collateral and non-real property collateral, and thus apply equally to both. Pursuant to Section 309.1, a pledge must be registered (filed) to be effective.

Section 307 of the Civil Code lists the items that must be set forth in the pledge agreement. Section 307 states that the pledge agreement must set forth:

- The names and places of residence of the parties to the agreement
- The mortgage item, i.e., its name, location and description
- The obligation secured by the pledge agreement, i.e., its size and duration of payment.

Section 307.6 of the Civil Code requires the pledge agreement to be signed by the creditor, the pledgor and, if the pledgor is a third party and not the debtor that owes the primary obligation to the creditor, by the debtor. Pursuant to Section 307.7, the pledge agreement must be certified by a notary. The notary reviews the agreement to ensure that it complies with the requirements of

[2] Azerbaijan had two post-Soviet normative acts governing pledges of collateral. In addition to the 1998 Law on Mortgage, Azerbaijan also passed a 1994 Law on Mortgage. The 1994 Law on Mortgage was reportedly accompanied by implementing regulations.

law and checks previously registered pledge agreements on the same property to ensure that the granting of the pledge will not violate those pledge agreements. Section 309 of the Civil Code continues the requirement of the 1998 Mortgage Law that the pledge agreement must be registered to be effective. Section 309.1 requires that the pledge of movable property be registered in the state general books of movable property, and that the pledge of real estate be registered in the state general books of real estate. The text of the Civil Code itself does not name the specific ministries or other executive bodies responsible for maintaining the state general books (registries) or handling certain other actions under the Civil Code. Rather, as is the case with other matters, the responsible bodies are named by presidential order or in subordinate legislative acts.

The Civil Code allows multiple mortgages to be created on the same item of collateral. Secured creditors have priority in the order of the filing of the mortgage.

a. General Confusion, Contradictions, and Omissions in the Civil Code and 1998 Mortgage Law

There is a widespread consensus that there are conflicts among the Civil Code and the 1998 Law on Mortgage, and that the provisions of the statutory scheme governing secured transactions need to be completed and harmonized. The Civil Code, which contains more than 1,300 sections, was prepared in a fairly short period of time with limited input from Azeri legal professionals, both academics and practicing attorneys. In a European civil law tradition, the Civil Code contains broad rules and precepts; lower level statutes and rules set forth concrete provisions and additional rules that flesh out the provisions of the Civil Code.

Complaints exist in the Azeri community that provisions of the Civil Code relevant to property and secured lending are vague and in places defy any logical meaning, in part reportedly as a result of the translation process among German, Azeri, Russian, and English drafts during its preparation. In addition, there appears to be uniform consensus that when reading the Civil Code and the 1998 Mortgage Law in tandem, an incomplete statutory scheme and conflicting provisions are encountered. Drafters of the Civil Code reportedly did not consider the preexisting provisions of the 1998 Mortgage Law. Representatives of Baku State Law School purportedly studied the proposed Civil Code prior to its enactment and informed both the Government and those working on the code of their concerns. However, this assessment team was advised that these concerns did not appear to have been taken into account by either group. Confusion is prevalent regarding Azerbaijani collateral law's scope, requirements, rights, and remedies.[3] This is compounded by the absence of a registry system for the filing of pledges on movable property, which is discussed in more detail below.

[3] The English translation of the provisions of the Civil Code relevant to secured lending is very difficult to read and, of course, is not the official Azerbaijani text. As a result, it was not possible for the assessment team to corroborate statements of vagueness, omission, and contradictions. The fact of uniform consensus among all those familiar with

Many legal professionals had a difficult time in identifying specific conflicts and areas of concern. In addition to deficiencies in the legislation itself, this is also apparently a reflection of the limited jurisprudence on secured transactions under the Civil Code, which is in turn attributable to the limited business practice of secured lending in Azerbaijan. The closed nature of the legislative process in Azerbaijan, and the associated absence of a debate within the business community regarding the provisions of the proposed Civil Code, also appear to have contributed to the confusion regarding those provisions of the Law on Mortgage are in conflict with, and rendered void by the Civil Code, on the one hand, and those provisions of the Law on Mortgage that supplement the Civil Code and continue to govern secured transactions, on the other hand.

A potentially critical problem in the Civil Code is whether the Civil Code adequately and clearly defines and distinguishes between those types of assets that are considered real property and those types of assets that are considered not real property. Concerns were raised that the Civil Code provisions regarding real property and non-real-property assets were confused, particularly with respect to assets that were kept on or affixed to land, but by their nature could be moved. Absence of definitional clarity at the outset of the code has the potential to create successive havoc and confusion regarding what an individual has a legal interest in and how that interest is created as an individual walks through the Civil Code's provisions regarding ownership, title, outright transfer, and pledges of property.

b. Property that Can Constitute Collateral, Describing the Property Constituting Collateral, and Obligations Secured

A clear and complete secured transactions regime allows for pledges on essentially all types of private property, including inventory, equipment, securities, accounts receivable, general contract rights, and cash. During the assessment work, various persons questioned whether the Azerbaijani secured lending law allows for pledges to be created on items not specifically set forth in Section 300 of the Civil Code, including equipment and securities. Respondents also stated that the Civil Code allows the creation of a mortgage on property owned by a debtor, but not on property interests short of outright ownership, such as leases. It also appears that Azerbaijani law does not unambiguously provide for nonpossessory pledging of crops or livestock. Local projects have attempted to take pledges in agricultural production for the purpose of establishing agro-industry through contract farming but have had difficulty enforcing

secured lending law and practice in Azerbaijan regarding the existence of conflicts in the law, and the occasional difference in conclusions on specific matters among those interviewed, compels a conclusion that the Civil Code and 1998 Mortgage Law do not establish a clear and complete legislative structure governing secured transactions.

such arrangements primarily because of cultural constraints.[4] However, their practices tend to be pragmatic, using security more for psychological leverage than for judicial enforceability.

Section 307 of the Civil Code requires that the pledge agreement describe the property pledged. However, the required specificity of the description is not clear. There appears to be a consensus that a description commonly used in some common law countries, such as "all inventory of the debtor" may be too general. In practice in Azerbaijan, notaries review certificates of title for the goods covered by the agreement prior to notarizing the pledge agreements. Where no certificates of title exist for the type of goods, notaries may ask to review the financial books of the debtor. Similarly, it is not clear if Azerbaijani law allows a mortgage agreement to include property - particularly equipment that does not constitute inventory - that the debtor may acquire in the future. Data from a survey not conducted by the team, and a reading of the Civil Code, suggest that a mortgage can be created on a floating pool of inventory and raw material. The extent to which a mortgage can be created that extends to proceeds of collateral, such as the cash proceeds or other proceeds of an item sold, appears also unclear. The law does provide for a buyer in the ordinary course of business to take title free and clear and for the lender to have an interest in the proceeds, but there is no practice, jurisprudence, or treatise yet to define the limits of these possibilities.

Another area that is not completely clear is whether future advances can be secured through a mortgage. Secured lending is efficient if it permits property that is the subject of a mortgage to secure debts of the borrower that may arise in the future, including multiple advances made by a lender under a term or revolving loan facility. Section 307.4 of the Civil Code requires that the substance, amount, and maturity date of the secured debt must be described in the mortgage agreement. In theory, it appears that this requirement could be satisfied by describing the maximum amount of the loan under a credit agreement and how the obligations secured, including interest, will be calculated. Some lenders claim to have secured lines of credit with multiple advances against real property through a single mortgage agreement property. However, the lenders with whom this was discussed did not attempt to foreclose against the real property and thus this approach may not have been tested in the courts. Similarly, data from a survey not conducted by USAID indicates that the ability to secure future advances, without repeatedly amending the mortgage document, is not completely clear.

Finally, the law follows practice in several other post-Soviet republics by requiring unnecessary detail in connection with any pledge of a business of a going concern. The 1998 Mortgage Law requires extensive detail, such as a full inventory of assets, presumably including typewriters,

[4] Respondents noted that attempts to finance future harvests failed because of lack of understanding of the nature of commerce and supply contracts. Agro-producers prepurchased a crop before harvest, only to find that the farmer sold it to a higher bidder when it finally came in and then thought that paying back the original purchase price made the producers whole. The farmers did not understand the concept of cover, the time value of money, or the fact that value-added producers needed products, not just their money back.

computers, and chairs as well as business inventory, for the pledge to be effective and enforceable. As a practical matter, this inappropriate level of detail will reduce or eliminate the use of this otherwise valuable approach to secured financing.

c. The Quandary of Where to File to Create a Mortgage Interest

Because of the absence of both an established registry under Section 309 of the Civil Code and the associated implementing regulations setting forth the scope and processes applicable to the registry, Azerbaijan does not presently have a regime that effectively allows the pledging of non-real-property collateral. This gap in the legal structure has created confusion among all those interviewed regarding which registries to work with to register mortgages on non-real-estate collateral and whether those bodies will have jurisdiction in the future. This confusion has extended to which bodies will have authority to register mortgages on real property collateral.

The promulgation of normative acts or other implementing rules for the registry may help reduce the confusion of where pledges should be filed. The Millie Mejlis is reported to be working on a draft law on the Registry for Immovable Property; however, that draft has not yet been completed. Because of the summer break in the legislative schedule, and other matters expected to be handled by the Milli Mejlis, some persons questioned whether the law would be passed by the end of 2002.

It is important to emphasize that the absence of authorized registries under the Civil Code results in the absence of a way to create a legally enforceable nonpossessory pledge interest in collateral falling within the authorization of those pledge registries. As noted above, Section 309 of the Civil Code requires that the nonpossessory pledge must be registered to be legally effective. Some countries allow the creation of a legally enforceable nonpossessory pledge on non-real-property collateral, such as equipment and inventory, through the execution of a signed agreement by the parties complying with applicable law. In those countries, the registration of the pledge is not necessary to create the pledge but only to protect the lender's priority among other creditors who have an interest in the collateral or the assets of the debtor.

With the disclaimer that confusion exists within Azerbaijan regarding the registration process and which bodies will continue to retain their pre-Civil Code authority, and that in the current absence of established registries, disputes may exist among governmental bodies regarding who should maintain various registries, a fair summation of the present approaches and authorities to filing of pledges on various types of collateral appears to be the following:

- **Motor vehicles.** Pledges of motor vehicles are filed with the traffic police. This is a common practice in many countries. The traffic police may not continue to have post-Civil-Code authority, however.

- **Securities.** The State Securities Committee is the authorized body for the registration of pledges of securities. The State Securities Committee has reportedly stated it does not have authority for pledges of limited liability companies. The authorization of the State Securities Committee is expected to be effective in the post-Civil-Code environment.[5]

- **State Property.** The MOED is the authorized body for registration of pledges on state property.[6] The Government of Azerbaijan does not create voluntary charges on state property as a normal practice. This authority is expected to be effective in the post-Civil-Code environment.

- **Real Property.** Issues relating to real property are discussed in more detail in the section on Implementing Institutions for Real Property. In general, pledges on apartments and on any land with buildings or other improvements on the land are filed with the Bureaus of Technical Inventory. Pledges of agricultural land with no buildings or other improvements are filed with the respective land committees. Presidential Decree No. 587 dated October 11, 2001, states that the Ministry of Justice has authority for the filing of mortgages on all real property. However, the Ministry of Justice has not established any registries at this time, and persons are consequently continuing to file pledges on real estate with the Bureaus of Technical Inventory or land committees, as appropriate. Pledges on crops on the land are [in practice] apparently created through filings on the underlying land. Interviews suggested that pledges of farm equipment can be made at the applicable Bureaus of Technical Inventory.

- **Airplanes and Maritime Vessels.** Special filing locations exist for mortgages of airplanes and maritime vessels, which is standard international practice.

[5] Presidential Decree No. 587 dated October 11, 2001 authorized the following bodies as the location for the filing of pledges: (1) the State Securities Committee for securities, (2) The Ministry of Economic Development for state property; and (3) the Ministry of Justice for all real estate, regardless of property or type. This decree referred to provisions of the 1998 Mortgage Law, however, practitioners uniformly described this Decree as setting forth authorities for purposes of the Civil Code.

[6] Some authorities have suggested that the Ministry of Economic Development also has authority over some private property. The Ministry of Economic Development, however, stated that it had authority for pledges over State Property only. As discussed in more detail at ____, there is in practice no place to file (and thus to create) a mortgage on [certain?] real property in Baku that has been privatized. The Bureau of Technical Inventory claims it has no authority to accept such mortgages, and such responsibility lies with the Ministry of Economic Development. The Ministry of Economic Development, however, does not accept mortgage filings on privatized property. ***[Wade Channel needs to nuance this description and ensure its accuracy. This issue arise during discussion at Shorebank]***

- **All Other Collateral.** It appears that no body has been provided with authority to establish registries for other types of collateral, including equipment, inventory, and accounts receivable. A Presidential Decree dated August 25, 2000, instructed the Cabinet of Ministers to submit to the President of Azerbaijan projects governing the establishment of operations of the official registries of movable property; however, the team is unaware of any such recommendations issued by the Cabinet of Ministers.

d. Enforcement of Unpaid Credit

Sections 317.1 and 319 of the Civil Code provide the secured party with the right to have the pledged property sold following the debtor's payment default. The "first in time rule" of filing governs under Section 320. If multiple creditors have registered pledges on the same property, the sale proceeds, net of the expenses of the sale, are sequentially distributed to mortgagors in the order of the registration of their respective mortgages.

The Civil Procedure Code, and the Law on Enforcement of Court Decisions passed in March/April 2002, set forth procedures for obtaining a court order for the sale of property, for the enforcement of the court order, and for auction of collateral. A creditor may use the streamlined procedures set forth in Sections 275 - 284 of the Civil Procedure Code to obtain the court order if the debtor does not dispute any matters. The Law on Enforcement of Court Decisions sets forth detailed procedures and time periods for securing enforcement of a court decision. If, as has been stated, the various time periods in the Law on Enforcement of Court Decisions are only guidelines, the new law may be limited in its ability to provide a more expeditious process for the disposition of collateral. As is discussed in more detail at ____ ***[cross reference to real property or commercial dispute resolution sections as appropriate],*** the legislative framework provisions contain many opportunities for delays both during the court procedure (including when the defendant does not come to court) and during the time the bailiff is charged with executing the court order. In addition, delays by debtors and their attorneys and multiple appeals render the process of a creditor's obtaining collateral lengthy and expensive. Auctioneers, who must satisfy licensing requirements, conduct the sale for the disposition of the collateral.

In many legal systems, creditors with a pledge of non-real-estate collateral have the option of having the collateral sold, with the net proceeds being paid to the secured party (any proceeds remaining after sequential distribution to all secured creditors are paid to the debtor) or if the value of the collateral is less than the debt, of keeping the collateral. Discussions suggested that Azerbaijani law provides the creditor with the option of keeping the collateral in this latter case. Similarly, many legal systems permit the creditor to use "self-help" to take possession of non-real-estate collateral following a default, if the self-help does not involve a breach of the peace. In these instances, the creditor does not need to get an order from the court to obtain the

collateral, even if the collateral must be sold because its value exceeds the debt. The notion of self-help involves a balancing of two competing concerns: protecting the debtor and providing an efficient mechanism for the compensation of the debt owned to the creditor. The picture for the availability of self-help in Azerbaijan with respect to movable collateral is not clear. Section 565 of the Civil Code provides for the use of self-help within the confines of law but does not provide clear parameters for use nor definitions of abuse. Elsewhere in the former Soviet Union, self-help has deteriorated into thuggery as legal enforcement has broken down, but this does not appear to be the case in Azerbaijan. Respondents had different levels of familiarity with self-help as a legal method of enforcement, with some believing that self-help is simply not available, while others believed that the creditor has the right to take the collateral and also to keep it if the debt exceeds the value of the collateral.

e. Additional Matters

There are several additional matters that constrain the establishment of an efficient secured lending regime in Azerbaijan.

Construction financing cannot be effectively practiced in Azerbaijan, because title does not pass to the owner until the property is completed, thus eliminating the capacity of the owner to pledge the property. Lenders and the National Bank expressed frustration with this. Currently, almost all construction is either self-financed or financed through intimates, or foreign partners, or parents rather than through banks. Although this has more to do with real estate lending than moveable property, it affects the overall lending industry.

As noted throughout this report, the lack of effective enforcement through the courts is a tremendous constraint to lenders. New legislation designed to speed the enforcement of simple actions, such as collection on a promissory note or unpaid debt, improve the environment with respect to black letter law, but the lack of an effectively functioning judiciary undercuts all legislation, no matter how well designed.

Illegal practices also undercut the overall secured lending market by raising the cost of the loans to debtors. Most notably, the payment of "hat money" was cited as a serious constraint to growth. This practice, very common in many transition and developing countries, requires the borrower to pay the loan officer a "fee" for getting the loan disbursed. In Azerbaijan, this payment was reported to be has high as 10 percent of the face value of the loan. The lender is then required to pay back 100 percent of the loan, plus interest on the entire amount. While this practice made economic sense under the Soviet system, where loans were not commercially based and where borrowers could often have debts written off or otherwise "forgotten," the impact in a commercial lending environment is substantial. Aside from raising the cost of capital to the lender, it increases risk of default and also provides incentives for loan officers to approve unbankable loans to obtain their cut.

Tax law also affects the overall system. Under existing legislation, lenders pay Value Added Tax (VAT) on the proceeds of loan collections. That is, if they seize and sell property to secure payment of the loan, they pay 29 percent of the sale value as a tax, without deductions for the expense of enforcement or to the overall tax situation of the lender. As one lender noted, "It is not profitable to foreclose on property."

3. Implementing Institutions

For Collateral Law, the primary implementing institution analyzed is the collateral registry, or its equivalent. In Azerbaijan, this is complicated.

The first problem is that the new Civil Code and the Mortgage Law require the registration of pledge interests for the underlying agreement to be enforceable, but no such registry exists. There is currently much discussion about the creation of a registry for movable property within the Ministry of Justice, but the team was unable to identify any concrete implementation plan for establishing the registry. In short, there is a transition and implementation gap; the law identifies the implementing institution in theory, but the Government has not yet built the institution.

There are registries for some movables, but confusion has increased in the past year because of poor definitions in the new laws and questions about who has jurisdiction over what type of property. Police currently have jurisdiction over registration of vehicles and any interests in those vehicles. This is not unusual in transition countries and can work, although most people prefer not to have to deal with the police at all, if possible. It is likely that there would be popular support for a change in this system, but it is not required. A greater problem currently exists than distaste for police registration. Users of the system report that the unofficial registration costs are so high that people are finding ways around the system.

The official cost of registering ownership of a vehicle or any pledge of that ownership is approximately $10. It was strongly rumored that additional charges of $150 were required for obtaining the registration. As a result of this rent-seeking, users have created methods of selling without selling by issuing powers of attorney that do not have to be registered to be enforceable between the parties. These require additional transaction costs, such as using notaries or lawyers to draft the power of attorney, and completely obscure the ownership interests in vehicles. Consequently, the police registry does not support the growth of secured lending for automobiles.

Equipment can be registered with the BTI or State Land Committee, but only if it qualifies as a fixture on land. In other words, movables must be converted to immovables before they can be registered. All other pledges on movables (including nonpossessory interests in company shares)

fall into a historical, legal gap. The earlier laws simply did not foresee the registration of pledges in the many items of property that can be registered in mature economies. Development of nonpossessory secured lending will simply have to wait until the registry is created. In the meantime, most financing is done through savings, possessory pledges (such as pawning gold or other items of value), or family relationships. Commercial lending, at least on a smaller scale, is handled almost exclusively by foreign-funded projects.

Creation of a collateral registry is essential but will not necessarily support the expansion of credit unless structured properly based on changed understanding. The law, as currently enacted, evidences a misunderstanding of the purpose of registration. In a market economy, registration is for protection of the *lenders and buyers*, by providing evidence of the pledge to other potential lenders or buyers so that they cannot compromise the lenders' interest. Consequently, it is not necessary to register the underlying contract, the terms of the loan or financing, or even the amount of the interest, because the registration serves only as a notice to anyone considering activity with the debtor that there is a prior interest.

Current concepts of registration, as embodied in both the law and practice, suggest that Azerbaijan takes a protective or control approach. The actual underlying transaction must be registered, not just the secured interest, and the transaction is not even a legal obligation unless it is registered. This raises the cost of the overall transaction, provides bases for additional rent-seeking behavior,[7] exposes nonpublic information to the public, and does not protect the lender in any way. It also does not protect the borrower, because instead of preventing usury or abuse, this overly controlling system prevents lending. Any project to create a new registry for movables or otherwise rationalize existing registries needs to ensure lender protection.

The current registry regime also suffers from confusion among users. Aside from issues of which registry to use, frustration was expressed that "people do not know how to register things correctly." This is not surprising in light of the numerous legal changes in the past few years, complicated by the absence of clear, detailed implementing regulations. Moreover, each existing registry has different, unpublished rules, which may even vary among clerks within the same registry. Future registry work will therefore need to address adoption of uniform procedures and user education, preferably within a context of customer-oriented service.

Existing practices in secured transactions reflect the problems in the system. Pledges are being filed in various existing pledge registries, with or without legal clarity, leaving the efficacy of such pledges uncertain. Although this presumably makes the pledge enforceable, it also

[7] It is common practice in the developing world for bureaucrats charged with reviewing documents to find "problems" with the underlying agreements that can be fixed for a fee, or that can be used to discriminate against politically, ethnically, or religiously disfavored interests. Respondents in Baku report that registrars do not currently comply with the requirement to provide a detailed written explanation when rejecting an application, suggesting that the environment is conducive to rent-seeking.

increases risks and costs of enforcement. Debtors' lawyers have been reported to challenge the effectiveness of the filing, leading to delays in the proceedings as well as costs of prosecuting the claim. A claimant may also be caught in a legal "Catch 22," in which the court will not honor the pledge if it was not registered with the Ministry of Justice, which does not have a registry.[8]

The establishment of a registry system is a necessary foundation for future growth in secured lending, but it is unlikely by itself to support increased lending in the present environment, particularly among small and medium agricultural producers and agribusinesses such as processing facilities. Additional agricultural lending will require a sufficiently capitalized banking sector with credit institutions willing to lend outside of Baku and to make smaller loans, a situation that does not currently exist. Costs and risks of banking are considerable and have caused the recent closure of two internationally savvy commercial banks - Bay Bank and HSBC. According to various respondents, these banks were simply unable to obtain a sufficient return on investment and compete in the current market.

Although the overall registry system is highly problematic, it should be noted that users tended to find the services, when rendered, to be satisfactory. Users reported no particular problems with organization or efficiency of the registries and noted that they were able to retrieve information or certified documents within a reasonable period. In other words, the registries seem to be organized with sufficient archiving taking place at present to ensure availability of information. Official fees for services were considered reasonable, but there was unanimous agreement that official fees were only one part of the cash price for services.

4. Supporting Institutions

a. Courts and Bailiffs

Courts and bailiffs are covered more fully in Section D, Commercial Dispute Resolution, but can be noted here for their negative impact on the availability and health of the secured transaction regime. Respondents note that courts can provide just decisions, if forced to, but generally cannot be relied upon to provide appropriate rulings based on law. Some creditors are using the courts as one means of enforcing payment, but the delays, expense, and difficulties in attaching property severely reduce their utility and undermine public confidence.

Several lenders described the use of moral suasion, group guarantees, community pressure, and other nonjudicial pressure techniques instead of courts. They are also relying on technically unenforceable contracts – that is, *unregistered* pledges – as the basis for granting credit and

[8] "Catch 22" comes from the novel *Catch 22* by Joseph Heller and describes requirements that cannot be satisfied because of contradictions in the requirements themselves.

enforcing payment. The transaction costs associated with enforcement are unnecessarily high and cannot be reduced yet through any formal means of Alternative Dispute Resolution (ADR), which does not yet exist in Azerbaijan. One respondent summarized the situation, "We have collateral laws, more or less, but we don't really have courts. So, what is the use of laws?"

Because of the recent effectiveness of the Civil Code (September 2001), the absence of the establishment of a collateral registry, and the absence of a significant lending, legal practice has not substantially evolved to fill in questions under Civil Code and pledge law. This is compounded to some degree probably by absence of published court decisions.

The incomplete and contradictory legislative framework contributes to judicial delays and disparate outcomes. Azeri lawyers emphasized that the absence of clarity in the legislative framework enables different courts to reach different results based on the same facts.

Bailiffs were characterized as not taking action to enforce a judgment that the court renders. They were also reported to expect payments and to use inappropriate pricing mechanisms upon sale of property that might eventually be seized.

b. Lawyers and Judges

Azerbaijan does not have an active or effective bar association, nor an association of judges, although a nascent association of Economic Court judges appears to be developing. A number of respondents suspected that the Ministry of Justice is not altogether supportive of any such judges' organizations because of conflicting interpretations of judicial independence. (This is not unusual in countries that have historically subjugated the judiciary under the executive branch, but official resistance to change appears to be stronger than average in Azerbaijan.) As a result, there is currently no group of legal professionals who monitor the need for legislative reform and amendment, or who can be relied upon to lobby for change.

In addition to the absence of any established organization of legal professionals, there is a general absence of Azeri lawyers who specialize in or focus on commercial law, other than in-house counsel or firms supporting international investors. Many of these lawyers supporting the foreign community are quite sophisticated in comparative international legal issues, but few have experience with secured transactions unless they have lived abroad. Even so, their level of understanding suggests that creation of some sort of association or roundtable from this important subset of lawyers would be useful in pursuing reform.

c. Notaries

The value of notaries in the secured transaction framework has to some extent been increased by the dysfunctionality of the overall system. Although sometimes superfluous to modern registry systems, notaries provide some of the lender protections now missing in Azerbaijan, albeit it at a cost.

Unlike their counterparts in common law jurisdictions, notaries are legal specialists in the Azerbaijan legal tradition, doing much more than authenticate signatures and documents. As lawyers, they are capable of preparing the loan and pledge documents, examining the quality of documents submitted, and verifying the validity of certificates of title. They also maintain files of counterpart originals of all documents notarized, acting as a shadow registry of sorts. In the absence of a registry system, they are also legally responsible for damages if they notarize or legalize a pledge transaction if the debtor does not have good title to the property or if they fail to notify a lender of any prior interests in the property. (Respondents reported successful suits in which notaries were required to pay damages for these failings.) As a result, notaries provide certainty in transactions that is not otherwise available in the system.

This function as a "gatekeeper" results from the intersection of several legal requirements with the economic reality of Azerbaijan, not from design or market demand. First, loans and pledges must be notarized to be enforceable.[9] Second, notaries keep counterpart copies of all originals. Third, the number of notaries is restricted, based on population, so that most geographic areas have only one notary who can handle the transactions involving residents or property in that area because the population is not enough to have more than one notary. As a result, each notary (outside of Baku) has exclusive jurisdiction over all transactions involving property or residents within that area. This one individual can readily verify the legitimacy of the transaction and the ownership of the property and generally fulfills legal requirements for verifying identities, searching for existing liens, and confirming contractual conformity with the law.

Currently all notaries are state employees, but the law was recently changed to provide for private sector notaries who will be licensed by the Government upon successful completion of a test, which was being developed in 2002. The first private notaries were expected to qualify by February 2003. As more notaries begin to serve the same populations, the existing "funnel" will broaden so that parties could conceivably choose between notaries and have more opportunity for fraud.

[9] In the United States and some European jurisdictions, notarization provides nothing more than psychological solemnity and evidentiary proof that the parties to an agreement are who they claim to be. Documents that are notarized are perfectly valid and enforceable, however. Elsewhere, notarization actually creates a legal, enforceable agreement.

On the other hand, a registry system designed for protection of lenders lowers the need for notaries as gatekeepers. Thus their importance for maintaining the integrity of the system will decrease once such a system is established. In the meantime, however, they provide an important service.

Notaries are regulated by the Ministry of Justice through the Chamber of Notaries, which, while not a voluntary association, could serve as a counterpart for work with notaries. The team was actively sought out by the notaries to discuss possibilities for reforming the registry system. They also expressed interest in serving as advocates for improved lending practices through their role in explaining contractual obligations to the parties to any agreement they notarize. This could prove significant in a public education campaign, especially in overcoming popular misunderstandings regarding the differences between loans and grants.

The positive features of the notary system should not be overrated. A number of problems were also identified. First, numerous respondents state that the official fees for various notarial acts, which are set by law, were usually accompanied by unofficial fees, usually equal to the official ones. The overall transaction cost makes notarization for small loans potentially prohibitive. (Notary fees were recently lowered as a result of the intervention of the ABA, of which more is said below.)

Second, professional education, improvement, and quality are not effectively addressed through any review or disciplinary process. Few notaries (or other legal professionals) have a good grasp of the many new laws. Third, the practice of reviewing company books and records to verify the status of equipment subject to sale or mortgage can be highly inefficient and will be unnecessary under a lender-friendly registry system. Detailed investigations, combined with discretion, also enable notaries to second-guess lawyers for a party to a transaction. Institutions will be able to bypass this by hiring internal notaries once private notaries become licensed, but the average attorney will still have to satisfy the law and the notary in drafting any agreements.

Eventually, the service monopoly exercised by notaries should be reexamined closely and reformed. For now, however, notaries provide certainty not otherwise available in the system.

d. Specialized Services

Filing and retrieval services do not currently exist for movable property, because of the lack of a more developed system. As collateral lending eventually grows, the market should take care of this need. The need for such services will be less, however, if the registry system uses a centralized, electronic system that permits filings in Baku or outlying regions to be accessed by computer. This is the most desirable registry structure but is certainly not required for getting at least a basic structure in place.

In the area of legal education, both Azerbaijan University (AU) and Baku State University are interested in reform. AU is headed by a parliamentarian and is supported by ABA/CEELI with several significant legal programs. Neither school currently teaches secured transactions beyond a 10-hour unit within the course on the Civil Code. This is simply not sufficient for imparting useful knowledge for the practice of secured transaction law. New curriculum needs to be developed and adopted and will require some outside assistance to ensure a market-oriented basis and understanding.

e. Trade and Special Interest Groups

The ABA has been surprisingly effective in lobbying for changes in certain areas. The ABA successfully challenged a system of exorbitant notary fees that were damaging the lending industry, especially for somewhat smaller loans, and getting those fees reduced to their current levels, which are considered reasonable by most users. They are also currently lobbying for the creation of a collateral registry and will be an important counterpart for ensuring that the system is lender-focused.

The National Bank of Azerbaijan is the country's central bank and has a reputation for supporting reform in the banking industry. They have helped to draft a new law on banking, which is reportedly now with the Milli Mejlis for review. The Bank considers creation and implementation of a collateral registry to be a high priority. In addition, the Bank is supporting legislation aimed at removing impediments to extensions of credit, such as problems with foreclosure and evictions (for real property).

The AmCham issued a white paper on constraints to trade and investment last year, which mentions the collateral registry system. This does not appear to be one of the high priorities at this time, however. The AmCham is currently working with the business community and the Government on one issue at a time and will be a strong ally for change once secured lending comes to the forefront of its agenda.

The Confederation of Entrepreneurs (with the ABA as a member) is active in various reforms but is currently focusing on larger issues relating to the overall absence of a healthy banking sector in Azerbaijan, not just registration of pledges. In mounting a broad-based coalition for change, however, the Confederation should be included and would likely play an important role.

Because of the absence of a vibrant business market practice in secured lending, there is a limited pool of professionals that are knowledgeable and work in this area. A great deal of public and professional education will be needed to support any project activities in this area. Existing media and legal publishers can serve as a basis for such programs. Legal information is generally available through various legal publishers, although not necessarily easy to obtain from the Government. An executive decree establishing authority for the registry of immovable

property within the Ministry of Justice was difficult to find, and few of those who work with secured transactions were even aware of its existence.

5. Market for Collateral Law Reform

a. Market for Legislative Reform and Reform Of Implementing Institutions

Demand for credit, especially in the undercapitalized rural sector, has been described by one respondent as "insatiable." Indeed, there is an inherent demand for credit, including secured credit, in any situation where face-to-face lending is not sufficient to meet individual needs for commercial financing.

In Azerbaijan, this demand is currently quite diffuse and unfocused. Although the ABA supports creation of a collateral registry system, the more common theme is that demand is simply for credit, whether secured or otherwise. The necessary institutions that normally capture this demand and focus it for reform are either insufficient or nonexistent. The specific demand for a registry system as a basis for extending secured loans is not well understood or articulated.

Demand for legislative reform in this area is also diluted by three overarching issues. First, the banking industry is in disarray. Bay Bank and HSBC, two international banks with a reputation for success in difficult markets, have left or are leaving because the costs and risks make their operations unprofitable. Local banks do not service the market adequately but tend to serve only historical "elite" clientele and have little interest in expanding their services, especially in the existing environment. Consequently, demand for reform in collateral law is eclipsed by demand for a viable banking industry.

Second, negative economic pressures resulting from anticompetitive behavior have an adverse effect on the demand side, especially in potential areas of growth in the agricultural export market. Even unsophisticated producers base their investments (and thus need for investment capital) on the potential for returns. Currently, producer prices are being suppressed by unofficial but extremely effective export cartels in traditionally strong cash crops such as cotton and hazelnuts. Until the incentives are rationalized so that producers capture the benefits of increased investment, they will not incur the costs. This depresses the demand for credits, especially the larger credits that support mid-level lending not covered by small- and medium enterprises (SMEs) and not desired by the larger urban banks.

Third, corruption raises the overall cost of transactions, lowering the demand. At present, there is perception of an almost universal system of unofficial payments for all types of filings and registrations, starting with banks ("hat money"), notaries (duplicate fees), and registrars (expediting fees or "grease money"). Some of these payments may be small, but the aggregate total changes the cost structure significantly, especially on lower priced transactions. A registry system should be fast, transparent, and inexpensive, but the level of corruption in Azerbaijan will certainly diminish all three of these factors.

On the supply side, it is not clear that the Government of Azerbaijan is making establishment of a pledge registry system a high priority. On the one hand, the President has decreed that the Ministry of Justice is responsible for establishment of a collateral registry, but this decree is neither well known nor well funded. The Minister of Justice has named some personnel to identify gaps in connection with this mandate but has reportedly stated that the system has not been implemented because of the absence of funds and personnel.

It is also not clear whether the Government understands the need for legislative changes to support a modern registry system. The Milli Mejlis reportedly has identified some amendments needed for the Civil Code, but it is not clear that these relate to pledge provisions. Based on the poorly conceived registration provisions that currently exist (which are debtor-biased), technical assistance in capturing international best practices will certainly be needed for effective reform.

b. The Market for Supporting Institutions

The overall market for supporting institutions is weak; for institutions to support collateral reform, it is even weaker. As described elsewhere, there are a number of cultural and historical reasons for the general lack of supporting institutions. In the specific case of collateral law, both demand and supply are affected by the lack of a registry and poor understanding of the purpose and benefits of a registry. The combination of these factors results in little demand for supporting institutions, and therefore little supply.

D. COMMERCIAL DISPUTE RESOLUTION

1. Overview

The commercial dispute resolution segment of the assessment focused on courts and arbitral tribunals in Azerbaijan. This is a new area of the assessment, moving beyond the more limited questions on courts as implementing institutions that are found in the sections on bankruptcy, secured transactions, and contract.

Are courts in Azerbaijan well equipped to resolve commercial disputes arising between business entities? Are there meaningful out-of-court dispute settlement mechanisms available? At present the answer to both questions appears to be a resounding "No." Although special economic courts exist to resolve disputes between business entities, they are not perceived as an effective means to enforce property or contractual rights in Azerbaijan. Nearly all of the respondents interviewed expressed some dissatisfaction with the economic court system.

The commercial courts of Azerbaijan are referred to as the economic courts. They were established as recently as 2000. Economic court judges are still gaining experience and the system is relatively new. Overall satisfaction with commercial dispute resolution in Azerbaijan is extremely low. Respondents view economic court judges as corrupt and/or poorly trained.

The 2000 USAID Rule of Law assessment noted that "anecdotal evidence is that enterprises avoid the court system, preferring settling matters out of court to bribing judges and other court officials and risking incorrect decisions." In 2002, anecdotal evidence once again suggests that the same concerns remain about bribery, corruption, and a poorly trained judiciary.

The majority of cases before the economic courts are administrative disputes with Government bodies including tax, licensing, and privatization disputes. Azerbaijani lawyers and members of the business community stated that they tend to avoid the court system for resolution of commercial and contractual disputes. Private commercial disputes appear to be resolved informally rather than through litigation. Some respondents noted that informal community-based dispute resolution mechanisms, including the use of peer pressure and the influence of elders, were more effective than litigation.

Enforcement of court decisions/judgments is also viewed as a problem. A new law on the execution of court judgments came into force on April 2002. The new law is meant to address some of the existing problems by establishing concrete procedures and time frames for enforcement procedures. The regular civil courts handle labor and employment disputes. Foreign investors have more experience in civil courts litigating employment disputes with Azerbaijani nationals.

Despite the pessimism expressed by many respondents, some lawyers have successfully litigated cases against the Government. One company was reported to have successfully challenged a tax ruling although the appeals process was lengthy and expensive. A second case was litigated against the Parliament relating to a construction dispute. Persistence, time, and money appear to be the key to successful litigation in Azerbaijan. Most parties do not have the resources, financial or otherwise, to pursue litigation in such a determined fashion.

At present, there is no active commercial arbitration in Azerbaijan and no Azerbaijani court/chamber of arbitration, although one is under development. The oil and gas sector has incorporated international arbitration into their Production Sharing Agreements with the Government and presumably other foreign investors also do the same. There has been a low volume of international commercial arbitration as well. Respondents indicated that there have been delays and problems with enforcement of foreign arbitral awards through the domestic courts.

A new international arbitration court is being established in Baku for the mediation and arbitration of commercial and noncommercial disputes. The Eurasia Foundation funded this project, an Azerbaijani initiative. Given the systemic problems with the courts, out-of-court dispute settlement seems to be a more likely place to focus emphasis in the short term.

The assessment team was unable to meet with the Ministry of Justice. In many respects, the Ministry of Justice is central to the administration and oversight of the courts. The team was not able, however, to speak to anyone within the Ministry tasked with judicial oversight, training, or administration. Similarly, enforcement and execution of court judgments rests with a branch of the Ministry of Justice referred to as the judicial police (a new law labels them court executors). The team was unable to speak to anyone from the Ministry from this branch either.

2. Legal Framework

Azerbaijan is a civil law jurisdiction. As in other countries sharing this tradition, earlier decisions of the courts are not binding on subsequent courts, but the role of precedents (through the doctrine of consistency) is steadily increasing.

The court system in Azerbaijan is established in accordance with the Law on Courts and Judges. This law created a three-tier court system in Azerbaijan: courts of first instance, courts of appeal, and the Supreme Court). The courts are divided into courts of general jurisdiction, economic courts, and military courts. The law envisages a division of the courts according to the nature of the cases to be reviewed as well as the status of the parties. Commercial claims between legal entities are usually filed in the economic court.

With respect to the economic court, there is a division between the economic court of general jurisdiction and the economic court for disputes arising out of international transactions. There is a separate economic court that is competent to resolve disputes arising between foreign entities or foreign natural persons relating to international treaty rights. This special court was established pursuant to a presidential decree of June 17, 1999. None of the persons interviewed (including judges from the ordinary economic courts) were able to describe with certainty the role of the special economic court. Other respondents noted that, as a practical matter, all economic disputes are heard in the ordinary economic courts of first instance.

The decision of the economic court of first instance may be appealed to the economic court as a matter of right. Although the economic court is recognized as an independent court entity, appeals from the decisions of the highest body of the economic court can be brought before the Supreme Court.

The new Civil Procedure Code, entered into force on September 1, 2000, established 3 months as the general period for consideration of all claims. A judge may temporarily stop proceedings for various reasons. As a result, cases typically last longer than 3 months. State fees are high and are set at 10 percent of the value of the civil/economic claim. Courts are granted the right to waive or defer the payment of state fees in exceptional circumstances.[10]

The legal authority for the rights and obligations of the judiciary can be found in the Azerbaijan Constitution, the Law on Courts and Judges, and various government decrees and regulations. Article 127 of the Constitution sets forth judicial independence. Article 107 further states that judges cannot be removed during their term of office. Article 93 of the Law on Courts and Judges sets forth the qualification requirements for judicial candidates. Additional requirements are set forth in the regulations pertaining to the Juridical Law Council and the President's Decree on the Organization of Courts and the Support of their Activity.

There are several laws that create a framework for commercial arbitration. In 2000, Azerbaijan enacted the Law on International Arbitration and ratified the 1958 New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards. This convention provides for binding international arbitration of investment disputes between foreign investors and the state.

The new Civil Procedure Code inserted relevant provisions of the New York Convention so that Azeri courts may enforce foreign arbitral awards. The laws permit the submission of arbitration disputes in Azerbaijan and abroad and permit the enforcement of these awards in Azerbaijan.[11] Foreign arbitral awards may be enforced as long as they do not contravene legislation or public policy and reciprocity exists. Although Azerbaijani law permits the creation of a local arbitration tribunal, none currently exists.

[10] Article 110 of the Civil Procedure Code.

[11] It is unclear whether disputes arising solely between Azeri parties may be the subject of an arbitration. Respondents differed on this point.

In August 2001, a bilateral investment treaty between the United States and Azerbaijan provides U.S. investors with recourse to the World Bank's International Center for Investment Disputes. Azerbaijan is also a party to the World Bank Convention on the Settlement of Investment Disputes between States and Nationals and Other States and is a member of the World Bank's Multilateral Investment Guarantee Agency (MIGA) and the European Convention on International Commercial Arbitration of 1961. On January 3, 1999, Azerbaijan joined, with reservations, the Agreement on Mutual Recognition of the Decisions of Arbitration and Economic Courts of Members of the Commonwealth of Independent States countries signed on March 6, 1998, in Moscow.

The basic legal framework with respect to courts, the judiciary and commercial arbitration seems adequate. Further legislation or administrative rules would be helpful, however, with respect to court administration and record keeping. At present, parties have variable access to court records and judgments. More detailed rules with respect to evidence are also lacking at present.

3. Implementing Institutions

a. Background: Economic Courts and the Judiciary

(1.) Economic Courts

The economic court system in Azerbaijan is 3 years old. The economic courts, while new to Azerbaijan, are related in part to the former Soviet courts known as arbitrage courts. Article 26 of the Civil Procedure Code sets forth the jurisdiction of the economic courts. The economic court system has jurisdiction over a variety of civil, economic, and administrative disputes between parties that are legal entities or individual entrepreneurs acting in an entrepreneurial capacity.[12] Typical disputes include contract disputes, bankruptcy cases, and tax and privatization disputes.

[12] Article 26 of the Civil Procedure Code states that:

26.1 Economic disputes arising out of civil, administrative, and other legal relationship of legal entities, irrespective of the type of ownership and nature of subordination, and physical persons exercising entrepreneurial activities without the establishment of legal entity and with acquisition of status of private entrepreneur in a manner determined by the law shall be within the civil procedural jurisdiction of the Economic Court.

26.2 The following disputes between the parties specified in Article 26.1 of this Code shall be within the jurisdiction of the Economic Court:

26.2.1 Disputes relating to conflicts in respect of contracts stipulated by the law or conflicts submitted by the parties for consideration of the Economic Court

26.2.2 Disputes relating to modification or termination of contract; disputes relating to confirmation or execution executive and other papers in respect of fines paid in uncontested manner (without accepting)

Economic courts have several tiers. The courts of first instance are the local economic courts and also economic courts dealing with disputes arising from international agreements;[13] there are four local economic courts, with up to six judges serving on these courts. They are located in Baku, Ganja, Ali-Bayramli, and Nakchivan. Typically, a single judge will decide a dispute in the local economic courts. While the Economic Court of First Instance (Number One) in Baku has six judges at present, the other regional courts have fewer. A total of 15 judges sit in the Economic Courts of First Instance.

To commence a case, a party must first write a complaint letter and attach documents to support the complaint. Article 150 of the Civil Procedure Code requires that a complainant must attach to its complaint letter a document certifying delivery of copies of the claim petition and other attachments to other parties in the case. Parties commencing a case must pay a fee into a special bank account maintained by the state. Proof of payment must be included with the plaintiff's complaint.[14] This approach avoids problems and bottlenecks found in many other countries, where the courts alone may serve papers on other parties.

Under Article 151, the court has 2 weeks from receipt of the claim petition to accept the petition. Articles 154 - 156 provide the defendant with the right to file a response and a counter-claim. The Civil Procedure Code also provides measures for securing a claim through a seizure or impoundment of property of the defendant (respondent). There are provisions for challenging a court order to secure a claim.

Within 20 days after the court has accepted a complaint, consideration of the case should commence. Deliberations should finish within 3 months. Delays, however, do occur.

26.2.3 Disputes raised by state authorities, local self-regulating bodies, and institutions authorized to exercise control with respect to payment of fines, except for uncontested payment of fines further to the requirements of the law

26.2.4 Disputes relating to recovery of cash written off to the budget in an uncontested order with breach of the provisions of laws or other normative acts by institutions authorized to exercise control

26.2.5 Disputes relating to declaration as invalid of legal entity's foundation documents

26.2.6 Disputes relating to declaration of physical persons and legal entities insolvent

26.2.7 Disputes relating to payment of taxes.

[13] Article 27 of the Civil Procedure Code sets forth the jurisdiction of the special court: "The Economic Court of the Azerbaijan Republic on Disputes Arising out of International Agreements shall have jurisdiction over cases with participation of physical persons and legal entities of the Azerbaijan Republic as well as foreign legal entitles with foreign investment, international legal entities, foreign citizens exercising entrepreneurial activities, stateless persons."

[14] The fee goes to the state budget administered by the Government. Courts are then financed by the Government.

According to respondents, a court will stop the case as a means of delaying the time for rendering a decision. The judge keeps the file until execution occurs and then it is closed and sent to the archives.

The rules of evidence are contained in the Civil Procedure Code. Copies of documents submitted into evidence must be proven (signed) by a notary. As for testimony of a witness, a party must ask the court for permission. The court can accept or reject the testimony of the witness. There are no detailed rules of evidence outside of the Civil Procedure Code. This is one area where additional legislative or administrative reform might be useful.

Execution of court judgments occurs at various regional courts. Because economic courts cover more than one region, the execution order is sent to the appropriate regional court where the party against whom the judgment is being enforced is located. Court executors sometimes referred to as "judicial police" are located within the court themselves and report to the Ministry of Justice. As discussed below, a new law on the Execution of Court Decisions came into force in April 2002.

Parties have a right to appeal decisions of the economic courts of first instance. There is an Economic Court of Appeals. This appellate court hears cases decided by the Economic Courts of First Instance. The Economic Court of Appeals has the right to affirm the decision below, partially or completely reverse the decision below, and remand the case for reconsideration in the Court of First Instance. The appellate court may also repeal the lower court's decision and terminate the proceeding.

The Economic Court of Appeals consists of the presidium of 11 judges. Appeals are heard by panels of three judges. When a panel of judges hears an appeal, they consider the law and the facts de novo. This means that new evidence may be introduced and the judges are not bound by the factual determinations of the local Economic Court of First Instance.[15] The Court of Appeals is meant to render a decision within 2 months, but the process often takes much longer. One respondent suggested that appeals could take on average up to 15 months.

The Supreme Court of Azerbaijan is the highest judicial body to resolve civil and economic disputes. The court has a plenum and five cassation collegiums – including a cassation for economic appeals. Parties may appeal the decision of the Economic Appeals Court to the Court of Cassational Instance that deals with economic disputes. Appeals are submitted to the judicial board of the Supreme Court that handles economic disputes.

[15] Article 371 of the Civil Procedure Code.

Unlike the Court of Appeals, the Supreme Court may not review facts de novo. Rather their review is limited to substantive and procedural legal issues rather than the facts of the case.[16] Under certain circumstances, appeals decided previously in economic cassation may be heard by the full plenary of judges.

(2.) Caseload

The statistics provided during the interviews varied. The figures listed here should be treated as estimates since no published statistics were available. In 2001, in the economic cassation of the Supreme Court, 171 appeals were considered. The subject matter of the economic courts cases included -

- Challenge to validity of executive acts (e.g., licensing decisions)
- Contract disputes
- Disputes with the ministry of taxation
- Privatization disputes [17]
- Banking and insurance disputes
- Property disputes.

The number of disputes appears to be increasing. In 2002, the Economic Cassation Court had considered 147 cases as of the date of this report. As for the Economic Court of Appeals, in 2001, it considered 408 appeals out of a total of 2,500 complaints filed at the Court of First Instance. In 2002, 1,100 complaints were filed as of June 2002 in the Courts of First Instance, according to statistics provided by the Economic Court of Appeals.

The Economic Court of Appeals compiles data for the Courts of First Instance and its own court and provides these figures to the Ministry of Justice as well as the Supreme Court. The Supreme Court maintains its own data but does not have to submit such data to the Ministry of Justice. Reports are prepared on quarterly, semi-annual, and annual bases. The Chairman of the Economic Courts of First Instance has responsibility for collecting and analyzing data before sending it on to the presidium of the Economic Court of Appeals.

A large number of cases heard by the economic court relate to tax disputes and privatization. Why is this? First, many entities are more likely to challenge a tax decision to avoid or delay

[16] Article 418 of the Civil Procedure Code (Grounds for Repeal of Resolution or Ruling of Court of Appellate Instance). "Violation or incorrect application of material and procedural norms of law shall be a ground for repeal of result of ruling of court of appellate instance."

[17] (with the Government/Ministry of Development as well as between business entities and newly privatized companies rising from privatization).

paying certain tax payments and fines. When the tax authority challenges entrepreneurs, they are more likely to go to court. This is a new development, however, with the first significant challenge by a private sector enterprise having been filed less than 3 years ago.

Second, breaches of privatization agreements are another major cause of disputes. Many small businesses have been privatized, and there are disputes arising out of performance of the purchase and sale contract, as well as disputes concerning obligations of the privatized successor entity with respect to debts or contracts of the state-owned entity.

With respect to privatization disputes, sometimes contracts concluded with the former government entity are not fulfilled. One example is a dispute relating to a fish factory. The stated-owned company owed the creditor 300 million manats. The privatization occurred and the creditor has been unable to get paid although the company assumed the debts. The lawyer had the property seized (arrested), and the parties were able to reach an amicable settlement.

Several lawyers interviewed were involved with lawsuits against the Government. One lawyer represented a foreign company in a tax dispute concerning whether VAT should be levied on the company. The company took the tax dispute through the appeals process and was successful eventually. The appeals process, however, took 25 months and involved appeals to the Supreme Court.

A member of the assessment team was able to view an appellate hearing concerning an allegedly incorrect classification of the company's income by the tax authority. In this challenge, the company brought with it an attorney, the company accountant, and an expert auditor to testify before the court. The court heard arguments concerning interpretation of the tax regulations and calculation of net and gross income.

Another lawyer is involved in a lawsuit between a building company and Milli Mejlis over 2 million manats. On the other hand, a number of respondents noted they would be hesitant to sue the Government.

(3.) Court Administration and Record-keeping

Court administration is an area in need of improvement. At present, much of the court record keeping and filing is decentralized. Judges tend to keep their own records of the cases. It is unclear whether members of the public, who are not parties to a dispute, can obtain copies of court documents and filings.

Each Court of First Instance has offices that take care of some administrative and record keeping functions; complaints are given directly to the judges. The courts also have so-called juridical consultants - young lawyers who meet with citizens, reply to letters, and keep statistics.

The economic courts are not fully computerized. Although judges use personal computers, no centralized docket or case management system exists. Within the Supreme Court, for example, only the economic collegium has a computerized intranet network.

Opinions are not published and are not kept in a central registry or clerks office. Lawyers reported that obtaining a copy of court decisions in cases where they had represented one of the parties was often difficult to obtain. Lawyers have to seek decisions from the judges who heard the case rather than from a central clerks' office. Respondents complained that there were often substantial delays in obtaining written court decisions.

Data on the caseload of various courts is maintained by the Supreme Court and the Ministry of Justice. Some of the data appears to be maintained in handwritten ledgers - although this may be input into the computer at various stages. Data on caseloads were provided during several meetings with members of the judiciary, although such data is not published or made publicly available.

(4.) The Judiciary

To become a judge, a lawyer must have at least 10 years of experience in the field of law before applying to become a judge. Judicial candidates must take and pass an examination to be eligible for an appointment. To date, only one such test has been administered, in 2000.

In 2000, Azerbaijan tested all of its judges and judicial candidates as part of a larger program of court reorganization. From this test, judges were selected for the economic court. Approximately 1,000 persons sat for the written multiple-choice examination; 603 persons passed the multiple-choice exam and proceeded to oral examinations; 25 percent of the previous judges failed the examination. Oral interviews and examinations were used to select the final poll of judges. Approximately 310 - 330 vacancies were filled, although this number expanded with the reorganization of the courts. The exam tested candidates on previous laws that had been superseded. Thus, economic court judges, for example, were not tested on their understanding of new substantive economic law.

Respondents believed that political affiliation as well as bribes may have been used to secure judicial appointments. Indeed, one lawyer was reported to have received the highest score on the written examination but did not receive a judicial appointment because of affiliation with opposition parties. The President of Azerbaijan nominated candidates for positions on the Supreme Court and the Economic Court of Appeals to the Milli Mejilis for confirmation. All other judicial appointments are appointed by the President without need for subsequent confirmation.

There are a total of 31 judges in the economic courts. There are 15 judges in the Courts of First Instance, 11 judges in the Economic Appeals Courts, and 5 members of the economic cassation collegium.

Economic court judges on the Economic Court of First Instance have been appointed for initial terms of 5 years. It is unclear whether they will have to sit for a new examination at the end of their term or otherwise be subject to a formal reappointment process. Judges who were interviewed noted that the short length of their terms made it difficult for them to properly fulfill their duties because they felt that 5 years was not enough time to develop adequate expertise with the new economic courts. Judges on the Economic Court of Appeals and the Supreme Court serve for 10 years.

The judiciary is meant to be an independent body in Azerbaijan; judicial independence is guaranteed by the Azerbaijan Constitution. Nonetheless, a symbiotic relationship exists with the Ministry of Justice and the executive branch. The Ministry of Justice appropriates funds for the judiciary and is also responsible for overseeing court administration in terms of case management. The Ministry of Justice also oversees judicial training and certification. Court executors (previously referred to as judicial police) work for the Ministry of Justice.

One recurring sentiment is that judges feel pressure from the Government with respect to their adjudication. A previous report commissioned by USAID noted, "Almost any judge can be arrested on a corruption charge on an executive branch whim, communicated through the procuracy. That judges are aware of this probability is probably sufficient to keep them from considering any ruling that would not be in the interests of the state, the President, and his party."[18]

Anecdotes shared during interviews mentioned situations in which telephones might ring in a courtroom during a proceeding (the inference being that a government minister or other employee was calling to give the judge instructions as to how to decide the case). Other lawyers noted that judges often stated that they were hesitant to rule against the Government, even when they knew that the law favored the other party.

At present, there is no code of judicial ethics in Azerbaijan. The Supreme Court can ask the President to dismiss a judge who has committed a crime. The Azerbaijan Juridical Council, a seven-member body appointed by the President, is responsible for judicial selection and appears to have disciplinary powers. The procedure for removing a judge is unclear and is described as cumbersome. It requires a complaint to the Supreme Court followed by further consultation with the executive branch.

There is great room for increased judicial education and training. The Ministry of Justice houses a judicial education center that appears fairly dormant. Some respondents noted that the training sessions offered through the Ministry of Justice tended to be dull and repetitive.

Judges from the economic courts do not meet as a group regularly to discuss their cases and to share expertise. As of the date of this report, there is no active judicial association within the country. One judge mentioned the recent formation of an economic judges association. This was the sole mention of a judges association during the assessment. It is too early to tell whether this effort will be fruitful. ABA/CEELI has offered some training for judges. Technical Assistance for the Commonwealth of Independent States (TACIS) and the Council of Europe have also provided funds to the Ministry of Justice for judicial training programs.

Lawyers and business parties do not have much confidence in the judiciary. Some anecdotes suggest that there are a few honest and competent judges in the economic courts - although respondents varied in their perceptions of where the expertise lay - some found the Court of First Instance more independent and others found the Supreme Court more equipped to handle economic disputes. Many stories were provided of judges asking for bribes to make a decision in one party's favor. Political affiliations may also influence judicial outcomes.

During the assessment, after a visit to the Economic Court of Appeals, one of the judges asked to meet with the plaintiff's attorney ex parte, without the Government's attorney being present. The meeting apparently lasted one and a half hours although it is not known what was discussed during this meeting. This is an anecdotal example, however, of how judges may stray from conventional procedure during adjudication.

Some respondents (including judges themselves) view economic judges as too young and inexperienced. Some respondents noted that training by itself will not cure the problem. Judges need time to develop experience. Another problem was the large volume of new commercial laws. Judges are tasked with implementing new economic laws including a new Civil Code, bankruptcy law, and tax code. Judges do not receive training in courtroom procedure and process as part of their legal education or when appointed to the bench. Respondents noted that they need greater education in civil procedure in addition to substantive law.

Because of the lack of information sharing and coordination, courts appear to reach differing and inconsistent decisions on similar types of cases. Respondents also noted that various judges hearing the same case might reach completely different decisions. Others noted that the decisions do not analyze the facts and explain the basis for a decision. There is simply a recitation of the evidence presented and a ruling without any reasoning or analysis.

The judges appear to have access to published volumes, which contain the relevant laws of Azerbaijan. They do not appear to circulate their decisions among their colleagues. It is also unclear how frequently the reference materials are updated.

There appear to be relatively few bankruptcy cases and cases involving enforcement of security interests - hence the judges have had an opportunity to become familiar with laws dealing with bankruptcy and pledge/mortgage in a consistent and sustained manner.

There is no statute or rules of interpretation to assist courts with interpretation of government acts. Some respondents suggested the need for such a law.

(5.) Execution of Judgments

A New Law on the Execution of Judgments came into force in Azerbaijan in April 2002. Until the enactment of the new law, there was no specific law concerning the execution and enforcement of judgments in Azerbaijan. A large gap existed. Parties submitted their executions to a special branch of the Ministry of Justice. Court executors, previously referred to as the judicial police, worked according to the teaching of the Ministry and old Soviet practice.

Some of the problems that used to arise, for example, were that a court executor might take a drastic measure when arresting property to enforce a judgment. One example given was that an executor might stop activity in an entire factory in an attempt to enforce a monetary judgment against a party. While the judgment was appealed, the factory ceased to do any business and thus became insolvent.

For judgment creditors, the time it takes to enforce a judgment has been a consistent complaint. An individual has to first obtain a court order and then obtain the services of the court executor. Often the debtor absconds or moves or empties his or her bank account before the creditor can execute the judgment. The bailiff can delay execution and may be paid off by the debtor. Debtors may bribe bailiffs not to execute for weeks, months, and years. Creditors also have to discover where the assets are located.

Enforcement of decisions against government entitles has been another recurring problem. Government entities eventually comply with decisions requiring them to take administrative action. Respondents noted that a ministry or local authority might drag its heels when complying.

The new law on execution may still be ineffective because it provides continued discretion to the executor to send a judgment back to the court. This may create backlogs and delays - the same problems identified under the current execution regime. For example, Article 14 of the new Law

on Execution states that if the demands in the court execution order are unclear, the executor may ask the court for further explanation.

Respondents have noted, however, that judges sometimes are not specific enough in their orders as to how execution should be carried out, for example what types of assets should be seized. The new law appears to remedy this by stating more precisely the type of information that should be contained in an execution order.

The new law also provides procedures by which the debtor can complain to the court concerning the proposed execution and seizure of his or her property. The time period for enforcement varies from one month for court decisions (from the date when the order is complete) to 3 years for international arbitral awards and foreign court decisions.

b. Major Observations concerning the Courts and the Judiciary

(1.) Economic Courts Are Not Effectively Used for Commercial Dispute Resolution Between Private Companies and Entrepreneurs

According to many of the persons interviewed, economic courts are mainly used for administrative challenges involving a ministry or other government authority and companies - examples are tax disputes, small-scale privatizations disputes, licensing matters. Contract disputes between companies appear to constitute a smaller percentage of the court's caseload. The possible reasons given for this phenomenon include-

- **Inexperience.** Economic courts and judiciary presiding in economic court disputes are relatively new and untrained. Some perceive the judges lacking competence. One interviewee remarked that unless the lawyers point out the relevant law to the judges, they are likely not to know about the legislation or to read it before deciding the case. Within the past 3 years so many new commercial laws have been adopted or amended that it may indeed be difficult for anyone to fully grasp all of these changes.

- **Corruption.** Frequent mention was made of corruption in the economic courts (at various levels). Some people (including lawyers and entrepreneurs) opined that judges make their decisions based on who has bribed them or who has closer relationships with the Government (the Presidency, Ministry of Justice, etc).

- **Pressure from above.** One person who was interviewed stated that the economic court judges tried to be independent when the court was first founded in 2000 but were unable to do so. The reason? Allegedly, the judges face pressure from the President and executive branch, the Parliament, and the Ministry of Justice. Several anecdotes related

to phone calls being made to the judges during court cases telling them to change a decision.

- **Settlement.** Nearly every person interviewed mentioned that private companies and parties are likely to resolve their economic and commercial disputes themselves. The reasons given for this included that the courts were not effective so parties settled rather than litigating. Others mentioned that it was the Azerbaijani way to resolve a disagreement informally rather than suing. There were repeated references to Azerbaijani customs or unwritten practices that are used in business relationships. This is the reverse of what is found in many well-developed systems, where parties settle because the law is well understood or the courts are considered to be effective, not because they are hopeless.

- **Lack of robust credit sector and bankruptcy process.** There appears to be little commercial lending and even fewer foreclosures on pledged property. According to lawyers interviewed, there have only been four or five bankruptcy procedures in the economic courts. The economic courts, therefore, have not been able to develop a full range of practice in important commercial areas.

- **Jurisdiction.** Azerbaijan economic courts are not permitted to consider foreign law. Foreign companies are unlikely to use the courts if they must resort to Azerbaijani law as the governing law of the contract. (Note: this applies only to companies outside the Production Sharing Agreements (PSA) sector.)

(2.) Economic Court Procedure and Administration Is One Main Area in Need of Continued Improvement

Although no interviews were held with Ministry of Justice officials, interviews with judges and observation of the courts and court procedure indicate the following:

- The courts could benefit from computerization of their case management and record keeping. At present, there is great variation on how records are kept and whether computers are used to keep the records. For example, only one chamber (collegium) of the Court of Cassation appears to use computers for docket management.

- Court decisions appear not to be maintained in a centralized place (either at the Court of First Instance or appellate court, etc). Parties have to go to the judges to obtain decisions.

- Court decisions are given only to the parties. They are not disseminated more widely. At present, however, it is unclear what value they have because the decisions apparently state the facts of the case and provide the court's decision without any further analysis of

the law or explanation of the court's reasoning (i.e., they have little precedential or consistency value in their current form). There may still be some merit, however, for disseminating economic court decisions more widely as they will help parties to understand how courts are deciding certain categories of cases. Because of this lack of explanation, it was noted that parties find themselves arguing cases de novo on appeal and reopening questions of fact. New evidence can also be introduced on appeal.

- There are no detailed rules of evidence or other rules governing how parties submit documents to the court (e.g., authentication of documents).

(3.) Judiciary Needs Additional Training (Both Substantive and Professional)

There was unanimous agreement among stakeholders that judges need more training than they have received to date. This is due to the newness of the judges (especially first instance judges of the economic courts) and the newness of the laws that they must interpret.

The Judiciary and the Ministry of Justice have not engaged in sustained training programs or continuing legal education for the judges (e.g., the development of new economic laws in 2000 has not appeared to spur the Ministry of Justice or the courts to engage in comprehensive judicial education on these new laws).

There appears to be passivity among the judiciary - relying on donor organizations and NGOs to provide the training. ABA/CEELI was mentioned as a source of training. TACIS, Council of Europe, and German Society for Technical Cooperation (GTZ) apparently are running various judicial training programs in Azerbaijan.

There is no functioning judges association (government-sponsored or private sector).

(4.) Enforcement of Judgments Is Another Perceived Problem

Will the new law be effective? The law is too new to tell. Perceptions, however, are pessimistic. The new law appears to give discretion to the executor/bailiff to delay execution by sending an order back to the court for clarification, by giving the debtor additional time, etc. This is perceived as causing delays that will make execution ineffective.

Court executors are also perceived as corrupt. References were made to debtors being able to bribe the bailiff to delay or impede execution, for example.

c. Commercial Arbitration

As a practical matter, the choosing of a foreign forum and foreign law is recognized among Azerbaijani commercial entities, although the practical experience of actual arbitration procedure

is lacking. It is now established practice to provide for arbitration in a third country in international contracts. The United Nations Commission on International Trade Law (UNCITRAL) rules and the rules of the International Chamber of Commerce are the most frequently used frameworks for providing the rules of arbitration. Stockholm, London, and Geneva are the most popular fora selected for such proceedings. At present, lawyers and business parties in Azerbaijan have little knowledge of or experience with commercial arbitration. Respondents who represent foreign clients have had some limited experience with arbitration.

Foreign law firms have attempted to enforce a couple of arbitral awards in Azerbaijan's courts. Anecdotal remarks suggest that judges may be unfamiliar with how to properly enforce an award. One judge was reported as trying to substitute his or her own judgment for the decision of the arbitrators. In another instance, when the decision was approved and delivered to the marshal, the marshal reportedly had to be bribed to enforce the award.

Two initiatives to establish an Azeri court of arbitration were commenced in 2001. The AmCham drafted a white paper and also a set of rules of procedure for such a court (to be housed at AmCham). This process has not developed more fully.

The Eurasia Foundation also funded an Azerbaijani project, which was originally to create a civil mediation program in Azerbaijan. Azerbaijan law provides for civil dispute settlement or mediation through so-called "third-party" courts. These dispute resolution mechanisms were supposedly modeled on older customary dispute settlement mechanisms (such as use of tribal elders to resolve disputes). The court will also offer what Azeri law refers to as "third-party courts" – this will be arbitration for natural persons in civil disputes. Apparently judges are supposed to advise parties in civil court of this option, but to date, this mandate has been meaningless since no process exists.

To date, the Eurasia funded project is more advanced and is meant to commence operation within the next several months. The major impetus for the arbitration projects included (a) need for alternative to economic courts for foreign companies and (b) need for faster process for commercial dispute resolution (interviewees view the courts as places of interminable delay, and the appellate process leads to a possible circular and time-consuming trip through the courts on appeal and remand).

The project funded by Eurasia involves funding a new Azerbaijan Institute of Arbitration. The Institute will be structured as an NGO and is modeled in part on regional arbitration courts formed in Russia. There has been some contact with Russian and Turkish arbitration programs for assistance. The director of the project is an influential human rights lawyer who is the head of a newly created Center for Appeals to the European Court of Human Rights.

To find third-party neutrals, the project leaders placed an advertisement in local newspapers. The Institute held initial arbitration training and then administered a test to participants. Based on the test, a preliminary group of persons was selected as mediators/arbitrators. Thirty-three persons have been selected out of 150 candidates. The group includes nonlawyer experts in various industries (e.g., oil and gas), lawyers, representatives of NGOs, and village elders. The new Institute will have a section devoted to civil disputes between individuals - this was traditionally the role of third-party courts. Disputes in both the commercial segment and the civil mediation wing will be binding on the parties.

The Eurasia project has used innovative means to educate the public and the business community about the benefits of ADR and arbitration. The Institute leaders announced the creation of the Institute via a television show on an independent channel. They hosted a talk-show-style program that lasted for 1 hour, which included discussions regarding arbitration. A video that includes a demonstration of arbitration and mediation has also been produced and is available for viewing. The television station received more than 500 telephone calls after the show, including calls from businesses that are interested in using the arbitration service. An office for the Institute was provided by a commercial organization that watched the show.

Although the Institute has begun its formation, many details need to be worked out. The cost of proceedings has not been set - somewhere between 1 and 10 percent of the amount in controversy is what is provided in the Stockholm regulations.

The credentialing of arbitrators is another issue. Beyond the initial training, there has been no further development regarding additional training or certification of the arbitrators. This may be a major obstacle because the experience of the arbitrators will be an important factor for foreign parties who are deciding whether to use the arbitration scheme.

The court of arbitration will offer commercial arbitration for foreign and Azeri companies and entrepreneurs. The Law on Arbitration from 2000 refers only to disputes with at least one foreign party, but the lawyer who is heading the arbitration project insisted that the 2002 Law on the Execution of Court Judgments permits domestic arbitration.

Clearly, there will be need for additional work in the arbitration sphere including-

- Continued education and training of arbitrators and lawyers who will be involved in arbitration practice before the court
- Creation of credentialing mechanisms for commercial arbitrators
- Help with developing a viable economic model/fee structure for commercial arbitration as well as the third-party court arbitrations for individuals

- Increasing awareness of commercial arbitration practice and law at the university level and in the business community.

4. Supporting Institutions

There are relatively few supporting institutions in Azerbaijan in general. Those that exist are not working to effect change in the commercial dispute resolution system in Azerbaijan or to improve the performance of the judiciary in any demonstrable manner. One of the reasons for a lack of vibrant supporting institutions may relate to problems that NGOs have encountered in gaining formal legal status. The Ministry of Justice has a specific Department for the Registration of Legal Entities. NGOs, including legal NGOs, have experienced delays with respect to obtaining the approval for formal legal status from this department.

a. Ministry of Justice Judicial Training Center

The Ministry of Justice operates a judicial education center. It is unclear how active this center is. An ABA/CEELI calendar did list a conference on judicial ethics scheduled in June 2002. The Council of Europe has recently funded a program to work with the Ministry of Justice and the Judicial Training Center to offer new programs for judges, and the TACIS program of the European Union (EU) has also provided funding to the Ministry of Justice for training programs. Judges who participated in the assessment mentioned private conferences and training programs administered by ABA/CEELI but did not provide details of the Ministry of Justice training programs.

b. Bar Associations

There appear to be a few professional associations for lawyers in Azerbaijan. If they do exist, however, they appear to be inactive or dormant. There is a Lawyers Association and a Legal Education Society, which provides published analysis of legislation free of charge. One of the reasons for the free publication is that lawyers appear unwilling to pay for books, such as a book of sample contract forms.

The most active organization in Azerbaijan is the Young Lawyers Association (YLA). This group was formed in 1999 as an NGO. YLA has approximately 100 members - 20 of whom are very active. It also has 5 - 6 full-time staff. YLA operates with funds from donor organizations. YLA is active with legislative commentary through several commissions of Parliament - the Law and State [Building], Human Rights, and Education Commissions. YLA has been invited to participate in drafting sessions because it has members of Parliament among its own membership.

YLA has an active student membership at various universities; 60 to 70 percent of its membership is students. It has created a program to send students to courts. The program is known as the Legal Improvement of Practical Skills project. YLA also produces written materials for students relating to the court visitation. Students go to court as observers to learn about litigation practice and to take notes about any human rights violations that may take place in the courtroom.

Baku State University is the only university to have a formal relationship with the courts where students are invited to serve as interns for practical training. YLA's court visitation program is an alternative for students who do not attend Baku State and thus serves a vital function.

YLA has a strong relationship with ABA/CEELI. With funding from ABA/CEELI, it has engaged in an active outreach campaign concerning the role of a new public ombudsman in Azerbaijan. This campaign involved the mass media (radio, television, and newspaper), training for trainers, and public information sessions for citizens throughout the country. The YLA also produced a Web site concerning the ombudsman and educational pamphlets. A YLA representative stated that the Web site campaign was less effective as a method of outreach whereas the columns and advertisements in newspapers were very successful.

The Government established the post of ombudsman in a new law approved in December 2001. The ombudsman is meant to field complaints from citizens against various branches of the Government and investigate and attempt to resolve them. ABA/CEELI reported that it was very pleased with the work of YLA on the ombudsman project. (Note: As of the date of this report. the ombudsman did not exist.)

YLA also offers legal advice to citizens through a hotline and plans to help citizens prepare complaints for submission to the ombudsman when the ombudsman is operational.

c. Judges Associations

Judges tend not to meet frequently as a collective. Respondents provided mixed views on whether judges did convene. There are no regular meetings, for example, of the various Economic Courts of First Instance. The Economic Appeals Court and the Supreme Court do invite colleagues from the Court of First Instance as well as younger/newer judges to visit and to sit in on deliberations and discussions. These meetings appear to be irregular and not institutionalized.

There is currently no formalized judges association and the Ministry of Justice is believed to discourage judges from forming such an organization. There may, however, be a newly created Economic Judges' Association. One of the judges interviewed stated that she had helped to

found the association. She noted that there was a general judges association in the process of being formed as well.

d. Judicial Police and Court Executors

The assessment team was unable to meet with a representative of the Ministry of Justice directly involved with court execution. As noted above, respondents nearly universally identified court execution as a major impediment to effective commercial dispute resolution in Azerbaijan. In other words, improving the court system is one hurdle, but effective enforcement of judgments is also crucial to a well functioning dispute resolution system. Court executors appear to be susceptible to corruption. Donors should monitor the impact of the new law on execution to see if it has an impact on the enforcement process.

Some respondents were critical of the placement of execution/enforcement within the executive branch rather than the judicial branch. Suggestions were made that enforcement should be handled by the courts directly.

It should be noted that no respondents mentioned that parties used physical violence, thuggery, or coercion as a means of enforcing judgment. There were no references to extra-judicial executors in Azerbaijan. Hence, parties tend to try to resolve disputes directly with the other party but do not use illegal means for doing so - save for corruption and bribery.

e. Chambers of Commerce and Other Business and Industry Associations

The AmCham is an active organization with strong involvement of the international legal community. The president is currently a lawyer; AmCham also has a legal committee, which has been involved with legislative commentary on the tax code and the labor code. The Legal Committee has proposed the creation of an arbitration court and has done at least preliminary conceptual work to develop rules of procedure for such an entity. The Legal Committee has many projects under consideration and therefore has not taken the arbitration scheme further in recent months.

The Azerbaijan Confederation of Entrepreneurs (CFA) is an organization that represents various business associations throughout the country. This organization also has working committees and has considered legal issues and draft legislation. The CFA appears to be an active organization. Commercial dispute resolution and arbitration are not topics that have been addressed by the CFA. CFA might nonetheless be a useful organization to partner with on outreach and education campaigns relating to commercial arbitration.

f. Law Schools

Some interesting initiatives have developed at the law faculties of several universities relating to the training of law students for court practice. As noted above, YLA has created a program of courtroom visitations to observe litigation proceedings. Such visits are followed up with

discussion sessions where lawyers recap and ask students to share their experiences and observations. YLA's program is an important one because it provides new avenues for law students who attend universities other than Baku Stat University. Baku State is the only law faculty that has a formal internship program with the courts. At least one law faculty – Azerbaijan University – has a new legal clinic where students work with and provide advice to clients. This type of practical skills training is important and might be further expanded.

In addition to traditional law faculties, special programs relating to business law (referred to as legal regulation of the economy), international economic law, European law, and oil and transport law have arisen. For example, Western University, a private university, offers bachelor's and master's degrees in these subject areas. These programs allow students to practice as legal consultants with companies and law firms. Students may not, however, practice as advocates.

g. Legal Information Industry/Sector

The assessment team received varying responses on the availability of laws. New legislation and presidential decrees are published after enactment or promulgation and appear to be available through commercial publishing companies. One company has created a CD-Rom that contains Azerbaijan commercial legislation. Availability of laws for judges also appears to vary - there are hardbound volumes, which contain major economic laws, tax code, etc. Some of the team members, however, interviewed judges who seemed to have limited access to laws in their chambers.

Some of the problems identified by respondents included -

- Not all laws are published in a consolidated format once amended, although major laws such as the tax code would be reenacted and published in a consolidated format.
- Some normative acts may not be easy to obtain (e.g., promulgated by a ministry but applicable only to a specific sector); same with municipal decrees.
- The major gap relates to court decisions. There is no formal dissemination or publication of court decisions.
- Laws also appear not to be available to the public in centralized locations such as a library or legal resource center (e.g., at a university or Ministry of Justice).

5. Market for Commercial Dispute Resolution Reform

Is there a demand for change within the economic court structure and the judiciary?

This is a difficult question and the answer is mixed. The majority of respondents seemed frustrated or doubtful on the current situation with respect to commercial dispute resolution and economic courts. Lobbying for legislative reform, moreover, does not appear to be a common activity among professional associations or the legal community.

The judges interviewed did not seem to champion reform, increased training, or collaboration, except for one judge who has created a new economic judges association. A similar reaction was generated from the private bar and entrepreneurs. There seemed to be a persistent negative view of economic courts (or indifference) but no one seemed to strongly advocate reform or improvement of court process. Some interviewees seemed to take the status quo as a given and court avoidance the default position for commercial disputes.

Interestingly, when the assessment team did ask a pointed question of interviewees about whether their clients would use the economic courts more if they were perceived as fair or efficient, the answer was invariably "Yes."

Nearly all respondents (especially potential users of the court system) perceived that the courts were ineffective and corrupt. At the same time, there did not seem to be a demand for alternative avenues for resolving disputes or for major reform of the court structure. This might represent a sense of fatalism or a sense that combating corruption is a much larger and systematic project - one bigger than reform of the court system.

Many lawyers and business entities are reported as preferring to work their disputes out rather than going to court. This may be due to distrust of the court system; at the same time, it seems that certain cultural factors also create incentives for parties to settle disputes rather than to sue. This may explain, in part, the apparent lack of champions for major court reforms.

Another reason why demand may not be focused is that the economic court system and the legislation, which the court applies, are all relatively new. This newness means that lawyers and judges alike may not have had sufficient time and experience to identify the major systemic weakness in certain legislation or court processes or to develop feasible alternatives to the existing court structures.

A few lawyers see themselves as pioneers - these lawyers are actively suing the Government, for example, even if they know that they may lose their case or have difficulty enforcing the judgment if successful. These lawyers appear to be a small minority and are choosing to reform the system from within rather than lobbying for more wide-scale reform.

As for improvements in legal publishing, some positive response was generated when respondents were asked about the idea of publishing judicial opinions on the Internet or combining them in some format. Lawyers noted, however, that the decisions need to have more

rationale and explanation for a court's decision for decisions to have any precedential or instructive value.

Lawyers varied on the opinions about how legally available commercial laws were. Some seemed comfortable with the level of commercial publications - others noted that the laws should be published in adapted format. The fact that the legal NGO that published material is unable to sell its books also demonstrates that the demand for these value-added services may not yet exist.

As for supply of a market for law reform in the commercial dispute resolution sector, the picture is equally mixed. It is unclear whether the Ministry of Justice is a willing partner with respect to building the capacity of the judiciary.

The supply side seems to be more positive with respect to out-of-court dispute resolution. The Azerbaijan Institute of Arbitration is poised to offer a new and value-added service for the business community and the public at large. Interviewees did not express the demand for arbitration. It seems that the lack of demand, however, may stem from a lack of awareness or knowledge of ADR and arbitration. Thus, public outreach seems an important first step toward generating demand for this type of commercial dispute resolution.

D. COMPANY LAW

1. Legal Framework

The framework for company law in Azerbaijan is built from four different statutes analyzed for this assessment:

- Law on Enterprises
- Law on Joint Stock Companies
- Law on Securities
- Law on Registration of Business Entities.

The first, the Law on Enterprises, states the general principles that govern six officially recognized types of commercial entities:

1. State enterprises (which are defined as entities in which the state holds all or a controlling block of the shares)
2. Individual and family enterprises (in which the owners are personally liable for all the enterprise liabilities)
3. General partnerships (in which, also, the owners have full personal liability)
4. Limited partnerships (which, as in the West, have partners with full personal liability and also partners whose liability is limited to loss of their investment)
5. Limited liability companies
6. Joint stock companies.

Of the six types of enterprises, the last two are what are generally called "companies," and it is these two (particularly the last, joint stock companies) that are the primary vehicles for foreign investment. In limited liability companies, shares may not be transferred except by inheritance or with the approval of the other shareholders. Joint stock companies are similar to corporations and as known in the United States and Europe.

As stated above, the Law on Enterprises lays down the "general" rules for these entities, and in doing so it often overlaps with other laws. For companies, the Law on Enterprises -

- Requires that every company have a charter and list its required elements (partly overlapping corresponding provisions of the Law on Joint Stock Companies)
- Requires state registration and lists the required documents for this (partly overlapping the Law on Registration)
- Sets out rules for liquidation including creditor priorities on liquidation (perhaps overlapping the Law on Bankruptcy, although that is not a subject here).

The Law on Enterprises also requires that each company have a governance structure consisting of (a) the shareholder meeting, (b) a "supervisory council" elected by the shareholders, (c) the "management," whose members may not also be members of the supervisory council, and who appoint (d) the company's "executive personnel." This governance structure, while lacking in needed detail (see further below), is similar to Western structures (particularly the German *Aktiengesellschaft* structure) and it is not inconsistent - as far as it goes - with Western corporate governance best practice.

The Law on Joint Stock Companies provides more detail than the Law on Enterprises, and it is the most important of the above-mentioned laws as regards corporate governance. It divides joint stock companies into two types: "closed," which are similar to limited liability companies in that shares may be transferred only with majority shareholder consent, and "open," which resemble Western corporations and whose shares are freely transferable. The law sets out several general provisions on governance matters including rules for shareholder meetings, voting, and access to information, but these provisions are sorely lacking in detail. Indeed, the strongest criticism of the Law on Joint Stock Companies is not that its provisions are wrong but that they are insufficient; the law simply lacks many provisions that are necessary to provide the business flexibility and shareholder protection that investors - including foreign investors - look for and demand in modern capital markets.

To some extent this insufficiency has been recognized by the Government, and in response, the State Securities Committee prepared a draft revised Law on Joint Stock Companies, which was reviewed by the President's Administration in preparation for submission to Parliament. This revision was drafted with the help of a foreign (English) expert as part of the Government's larger current project to replace the Law on Securities, which is described below. This revision would add to the Law on Joint Stock Companies two new chapters entitled "Corporate Governance" and "Protection for Shareholders." Those chapters include very helpful new provisions stating that a company manager has a "duty of care" much like the duty of care that directors and managers have under current U.S. law. The provisions also state rules for dealing with company managers' conflict of interest transactions similar to the rules stated in English company law for company directors and managers and increase the power of shareholders to sue a company. Those proposed changes are positive, but it must be said that the law will still be without many provisions that investors would look to for business flexibility and shareholder protection. This insufficiency can be best seen by the following list of matters that the new draft law does not provide for, but in the team's view, should -

- Clarify the rights of shareholders to information about the company including the extent of their access to a full shareholder list and to internal financial information
- State the essential terms, rights, and preferences of each type of stock, e.g., that common stock has one vote per share and that preferred stock is nonvoting except in special cases (such as when preferred dividends are in default)

- Expand on the standards for and restrictions on payment of dividends
- Specify detailed procedures for shareholder meetings - covering (for example) notice, agenda-setting, conduct of meetings, and proxy voting
- Restrict terms of directors (for example to 1 year with reelection permitted) so that shareholders can evaluate their performance and remove or reelect them at the annual shareholder meetings
- Require cumulative voting for directors and require some "independent" directors at least in large companies
- Provide for derivative lawsuits to enforce shareholders' rights
- Expand the rules for conflict of interest transactions to (among other things) include directors, their family members, and business associates
- Provide detailed rules for procedures such as mergers, charter amendments, preemptive rights offerings, and other major transactions, to avoid disputes in these complex situations.

The above list (plus many more items) was discussed with officials of the State Committee on Securities. These officials are keenly interested in assistance with such changes to avoid the need for amendments again in the near future.

A third relevant law is the Law on Securities. That law also contains important provisions relating to companies and investor protection, particularly rules for issuance of securities, disclosure of information in connection with securities issuance, and regulation of securities markets and of brokers and other professionals in that market. However those matters, while important, can (and for present purposes will) be considered beyond the normal definition of "company law." Further, as stated above, Azerbaijan has recently completed a comprehensive rewrite of the Securities Law with the help of a foreign expert, and the team was not asked for help on that.

Last to describe - but very important - is the Law on Registration of Business Entities. It became clear in the team's meetings that registration of companies is one of the greatest concerns of investors and the professionals (accountants and lawyers) who represent them. This concern has two aspects: the overly extensive documentation that must be filed for registration, and the administrative process and frequent time delays required for registration.

The Law on Registration of Business Entities requires considerably more documentation for registration than is required in Western countries, and many persons commented that much of this documentation appears unnecessary. As an example, to register a new company, a certificate is required from local authorities attesting to the correct address of a company founder; this can be difficult and time-consuming to obtain and even when obtained, it merely provides information that can easily be verified in other ways. The volume of documentation can be seen in a list of what is needed to register a branch office, such a list speaks for itself. It

includes multiple copies of more than a dozen documents including an application to the Ministry of Justice; the regulations of the branch, notarized and legalized by the Azerbaijan Embassy or consulate, the charter of the company, also notarized and legalized; the relevant extract from the Trade Register, also notarized and legalized; recommendation letters from a bank, also notarized and legalized; the company resolution establishing the branch; powers of attorney for the branch head, also notarized and legalized; copies of the branch head's passport; copies of a lease for the branch office; official stamps of the branch; and a receipt confirming payment of state duty.

Regarding process and procedures, the Law on Registration provides that registration must be effected within 10 days after the documentation is complete. In addition, the Law on Enterprises provides that registration may be refused only "if the rules determined in the law for establishing enterprises are violated" or "if the founding documents of the enterprise are in contradiction with the legislation of the Azerbaijan Republic."

As a practical matter, however, the Registry administrative personnel have very broad discretion in determining the correctness and completeness of filed documentation and, because the documentation requirements are not simple and objective, this often leads to delays. It has been pointed out that under the present circumstances registration of a company can, in some cases, take several months. Several interview respondents also perceived that delays were often deliberate, both for the purpose of extracting payments, and as anticompetitive measures to keep certain companies from commencing operations.

While not necessarily a matter of company law in all instances, the diagnostic deals with the issue of licensing under this subject area is a matter of convenience. For Azerbaijan, licensing of commercial activities is a recognized constraint to business growth. The requirements are excessive, with each individual activity having to be separately licensed, often by different authorities. It was noted that a company engaged in the food industry would need separate licenses to produce different products from the same input - for example, fruit jams and fruit juices. This licensing regime is popularly perceived to result from the culture of control held over from the Soviet regime, and from the revenue stream produced from official and unofficial fees. Abuse of licensing requirements was considered to be rampant.

2. Implementing Institutions

The principal implementing institutions are the Company Registry (with respect to registration of companies and company documents) and the courts (with respect to settlement of disputes and clarification of the law when clarification is needed).

The Registry is a part of the Ministry of Justice. The principal office of the Registry is in Baku, but there are nine other regional offices, each with jurisdiction of a specified local area. Registration filings by a company are required to be made in each registration office in whose jurisdiction the company has an office. This means that filings in multiple locations can be necessary for a single document or corporate transaction. This has been mentioned as a factor that increases the expense and time required for registration and has been cited in addition to the factors described above.

As indicated above, the registry officials have discretion to review almost every facet of a company registration. This stems from the tradition, prevailing in much of Europe, that registration of a company signifies compliance with all legal requirements. It effectively requires (or at least invites) the officials to examine the contents and the form of all the filed documents and even to review and pass on the work of the lawyer who drafted the documents, and to reject a registration that the official feels is deficient. This contrasts with registration in the United States, where only a single, objective unnotarized document need be filed, and registration can often be effected within minutes. The systems reflect two opposing theories of registration: one sees registration as an approval of the company's compliance with law and its capacity and fitness to do business; the other sees it as simply an act of providing information to the public as a condition to using the corporate form. Even taking the former view, however, the present filing and documentation requirements can be made simpler and more objective. That is, in fact, now happening in Eastern European countries that are reforming their laws.

Another significant fact is that the Registry is not computerized or centralized. Company records are kept manually, forms and filings are not and cannot be entered electronically, and there is not a single central office with all the company information from all 10 regional offices. This too is an area in which a need for reform is indicated, and that may be most feasible in connection with general simplification and objectification of the entire registration process.

The court system is more fully described above, in the section on Commercial Dispute Resolution. With respect to company law, the courts are supposed to settle disputes and clarify matters of law through litigation. In practice, they do neither. Most company representatives interviewed actively avoided the court system, and foreign companies provide for arbitration outside of Azerbaijan in their local contracts. As further developed elsewhere, there are two reasons for this.

First, the courts normally fail in their role of clarifying the law because judges and other legal professionals normally do not know the law. As noted, it is spread across a number of statutes, all of which are relatively new. With no continuing legal education under way to upgrade knowledge, even in the Economic Courts, there are few who know or understand the law.

Second, there is a perception of pervasive corruption in the courts, as noted throughout this report. Companies do not expect their disputes to be settled primarily in accordance with law, and thus avoid the courts where possible or try to influence the outcomes through payments or influence when not avoidable. As a result, the courts at this time fail badly as implementing institutions.

Various licensing authorities also qualify as implementing institutions, insofar as licensing requirements are required. These authorities are broadly perceived as ineffective and often corrupt. Complaints abound regarding delays in and costs of licensing, and a number of respondents complained that different authorities involved in licensing of different activities carried on by the same company will even have conflicting, mutually exclusive requirements. The result is that many companies choose to either forego opportunities or to operate without a license and run the risks inherent in "illegal" economic activity.

3. Supporting Institutions

For the most part, supporting institutions for company law are underdeveloped or nonexistent. There is a significant exception with respect to company registrations, however, in the area of private service companies that handle registrations for clients for a fee. Both the Registry officials and private persons have mentioned that these companies manage a significant portion of total registrations. Their advantage is that they (presumably) know both the documentation requirements and the personnel at the Registry. They clearly provide a practical means to deal with the complexity of registration, although they involve an expense that would not be necessary under a simpler system.

Other institutions are no stronger in company law than in other areas. The bar associations (the Azerbaijan Lawyers Association (ALA) and the YLA) are underdeveloped in general and are not currently focusing on company law matters through any committees or subgroups. AmCham represents an important sector of the corporate business community as well and has publicly complained of the numerous licensing and registration problems that are inhibiting commerce. While vocal, the AmCham is not enough to bring about these changes but is the only well-structured association pursuing change. AmCham could serve as an effective counterpart in pushing for reform as well as providing public education on issues of law. The Association of Entrepreneurs is also concerned with licensing and registration issues but does not yet have the structure or focus of the AmCham.

Eventually, it is anticipated that the law faculties will improve their curriculum on company law and their input on legal reform. They have not yet responded to the numerous legal changes through sufficient update of curriculum. They are not formally or regularly solicited for advice by Government in amending, structuring, or creating new laws, so their role in this area continues to be underutilized and underdeveloped.

4. Market for Company Law Reform

On first impression it might seem that the impetus for reform of the company law is limited, for perhaps three reasons. First, many of the country's wealthiest nonstate businesses are foreign companies, most engaged in some facet of the oil industry. These companies are "big boys" who are used to taking care of themselves in almost every legal environment, for example, they can afford to retain professionals such as accountants and service companies to register their companies, they can provide in their contracts for holding of funds and settling of disputes in other countries, and they have only limited need to use locally incorporated companies. Second, much of even the local business world is still in state hands, and state companies are not in need of the reforms suggested above. And third, the supporting institutions referred to above do not at this time seem organized for or prepared for a strong reform push.

However, this impression is belied by the above-mentioned project under which the Government has just prepared a new and improved Law on Joint Stock Companies and has now asked for the team's help. The Government officials with whom the team spoke clearly understood all the corporate governance and other issues discussed and stated clearly that they plan to use the team's ideas in the current revision of the law. The need for reform and revision is there, and the Government has recognized it and is moving forward on it.

With respect to problems of excessive licensing requirements, however, there is substantial demand for change. This issue has been cited frequently as a source of noncompetitive activity through improper influence exerted by de facto monopolies upon licensing authorities, as well as an expense that increases the departure of formal companies into an informal market. At recent "town meetings" with the President, the international and domestic business communities openly voiced this concern, and the President has publicly acknowledged that he has heard their expressions of displeasure. Whether the government is prepared to supply the reforms requested remains to be seen.

E. COMPETITION

1. Overview

The area of competition law is one of the least developed of the nine areas studied. The 1993 legislation itself has the proper orientation and includes considerable detail on the definitions and theory of monopolistic/anticompetitive behavior. Amendments to the legislation in 1997 provide for extensive theoretical government authority to force the termination of monopolistic activity and to punish it, though it is seriously insufficient in one critical area: the establishment of regulatory and implementing regimes for enforcement. The law could provide a workable basis for competition reform, however, if properly interpreted, and most important, if implemented in a meaningful way. Unfortunately, neither such interpretation nor implementation has occurred. The executive agency charged with implementing the law, for example, has seen its governmental status reduced and is now only a shell of an institution, with insufficient authority, funding, and staffing to fulfill its mandate.

Supporting institutions for this area are also weak. Although there is some statistical capacity within the government and within the private sector, there does not seem to be any group focused on or trained in economic statistics related to analyzing anticompetitive behavior. Complaints of monopolies and cartels abound, but there is no significant organized protest to champion the needs of consumers or voice the concerns of the agricultural sector, which is deeply affected by limitations on entry into agribusiness areas, as well by export and import controls.

2. Legal Framework

a. Legislative Basis

The *Law of the Azerbaijan Republic About Antimonopoly Activity (No 526)* was signed into law on March 4, 1993, and *Amendments No. 381-IGD* were added on October 10, 1997. The overall purpose of the law is stated simply and with no other elaboration in Article 1: "The Law determines organizational and legal foundations for prevention, restriction, and suppression of monopoly activity." The rest of the body of the Law, Articles 2 through 19, deals in great detail with definitions of prohibited activities and is clearly based on Western antimonopoly policies and law.

The law states specifically that it is applicable to all "legal entities and physical persons" in the territory of Azerbaijan, including Azeri Government entities and persons as well as private sector entities and persons. In addition, Article 2 states that instances in which the law will be applicable shall include "cases when agreements and contracts concluded with economic subjects, executive power, and administrative bodies [e.g., Azeri Government bodies] with physical persons and legal entities of foreign countries lead to restriction of competition in the

national market." This focus on the Government and its actual or potential anticompetitive behavior continues throughout the law.

Detailed definitions of monopolistic behavior and of government and private sector persons and entities that are subject to the law are presented in Articles 4 through 9. The core definition is that of "monopoly activity" as the "activity of economic subjects or executive power and administrative bodies which, being in one way or another form monopolistic, is directed to prevention of competition, its restriction or elimination (Article 4)."

As in several other former command economies, definitions of a "dominant position" (a "share in the market exceeding 35 percent or other ultimate figure specified by legislation as dominating") and of "natural monopoly" as monopolistic activity "where competition is impossible or inexpedient" (frequently thought to be in the areas of public utilities) are also included. In addition to these generic definitions, the law includes the rather more sophisticated concepts of market barriers (both entry and exit), and horizontal and vertical agreements "in order to avoid competition."

Of particular interest is the law's special focus on defining in detail (and declaring illegal) monopolistic behavior on the part of government bodies and state monopolies, at the national, branch (of central government), and local government levels. Articles 5, 6, and 7 are devoted to providing a litany of acts forbidden to governmental bodies. These acts read like a list of actual government interference with and impediments to private sector economic activity and include, *inter alia*, bans on the movement of commodities between regions, imposition of taxes or the provision of credit privileges that create unfair preferences, and restriction on foreign economic activity. The implication is clear that such government activities did in fact frequently occur at the time the legislation was written (1993). Recent interviews indicate that such activities remain prevalent and continue unabated (2002), in spite of the existence of the law.

Article 6, on actions by branch administrative bodies that are to be regarded as illegal, lists many of the same activities forbidden to the Central Government in Article 5. Additional acts are also listed and include interference in the privatization process, as well as the "ungrounded provision of financial and other privileges to [inefficient] or unprofitable economic subjects if such privileges are not stipulated by public interest and bring losses…." Also forbidden are the "establishment of ungrounded barriers to free entry of capital from one sphere to another" and "creating obstacles to formation of parallel structures for distribution, procurement, and sale of products." Once again, the law describes events familiar to observers of economies in transition. And also once again, recent interviews indicate that these same problems continue to be widespread.

"Local bodies of executive power (regional, city, and constituent administrative-territorial formations)" are dealt with in Article 7. The list of illegal acts is specific and discusses many of

the problems described by lawyers, businessmen, and donors in recent interviews. The list in Article 7 of seven activities deemed to be illegal once more repeats some of those listed in Articles 5 and 6 and adds the "use of objects of municipal property, resources of local budget and also local budgetary funds with the objectives of establishment of one-sided privileges for local economic subjects in cases when this might result in restriction of competition…." Another example of government interference in market activity is forbidden in paragraph 5: the "establishment of organizational-administrative structures or holding companies with the objective of achievement of dominating position in the market."

Articles 8 through 10 provide lists of sophisticated monopolistic activities, which are declared illegal and which apply to "dominant position" private sector monopolies, to "financial credit organizations," and to government bodies and private sector entities. Listed illegal activities include price fixing, boycotts, production quotas, conflicts of interest, tie-in agreements, and horizontal and vertical agreements used to engage in such monopolistic and anticompetitive activities. Antimonopoly control over "natural monopolies" (utilities and others so defined by the government) is said in Article 11 to be "accomplished separately."

b. Implementation Provisions in the Law

Provisions for implementation of the *Law About Antimonopoly Activity,* and the actual implementation since its enactment, represent the weakest points in this area of law and economic policy. As in other laws reviewed, the implementing governmental body is referred to only generally as the "respective executive power body" (Article 3). The article does go on, however, to grant apparent implementing authority, in that the "body can issue orders obligatory for the implementation in connection with violation of provisions of the present Law and carry out other powers in accordance with [this] legislation" (Article 3).

In several interviews with lawyers, businessmen, and government officials, it was verified that Presidential decrees in 1994 did in fact create a "State Antimonopoly Committee," with a government-level equivalent to a full ministry, with the apparent authority to issue obligatory regulations, or normative acts, which is consistent with the authority granted in Article 3. While such normative acts ordinarily have the force of law, those interviewed could not recall that the committee had ever issued such acts (and if it did, one interviewee commented, it never attempted to enforce anything).

In 1997, Amendments No. 381-IGD considerably strengthened Articles 13 through 19 of the law, which deal with "Means of Antimonopolistic Control." Additional controls were granted to the "executive power" (assumed to be the State Antimonopoly Committee) over the establishment, reorganization, and liquidation (except for cases of the liquidation of enterprises according to the judgment of a court) of economic subjects, including private and municipal enterprises, if such

action would result in a market share of more than 35 percent. How such a market share should be defined and calculated is not stated in the amendments.

Nonetheless, the statute states that any such establishment, reorganization, or liquidation must be "carried out on the basis of consent of the … executive body." Article 13 prescribes that the supporting documentation regarding sales and market share shall be those documents submitted for company registration and only those documents. In a clear effort to introduce some defined implementation procedures, the article further states that the executive power "should answer the request for establishment, reorganization, or liquidation within 15 days of receiving the application" and that should the enterprises take any action without consent, such action "should be considered as invalid by respective judgment of the court."

In addition to the new powers of required consents, the amendments also give the executive power the authority to force the desegregation of monopolistic companies, to require reports on business activities and accounts, and in certain instances to take other actions short of liquidation, such as imposing price controls, new tax rates or forcing other compensatory actions.

While these and others of the 1997 Amendments do purport to give additional powers to the executive power, especially regarding the right to information and the need for the executive power's consent to various actions, and in some instances refer to a procedure to be followed, interviews with lawyers and government officials confirm that no significant implementation of the additional powers has yet occurred.

3. Implementing Institutions

Although the Antimonopoly Committee was originally established as a State Committee in 1993 and was the equivalent in authority to a full ministry, the committee apparently never seriously attempted to exercise its powers, even after the 1997 Amendments that significantly increased its authority. A recent reorganization of the Government has seen the committee reduced to the Department of Antimonopoly in the MOED.

In a recent meeting with officials of the department, they noted that in spite of the authority and powers granted by the law, the department has no real power to compel action or cooperation from government or private entities. The department views its role as strictly advisory. It is seriously under-funded and consists of just 20 staff and one office in Baku.

The department currently works in three areas of policy: (1) competition, (2) the regulation of state and natural monopolies, and (3) unfair business practices and consumer protection. In all three areas, its work involves only the review of information and recommendations as to policy. Regarding the calculation of market share, for instance, the committee must rely on the Company Registry at the Ministry of Justice for statements of business activity and accounts.

In present circumstances, the Law on Antimonopoly has no enforcement program in place. Without action at the highest level of the Government of Azerbaijan, it is unlikely that any effective implementation of the law will occur.

4. Supporting Institutions

For the department to work effectively in its role as an implementing institution, it must have capacity to obtain, produce, and analyze sophisticated economic and statistical information. At present, there is limited capacity for this within the department, and limited outside resources through the supporting institutions.

Azerbaijan does have a number of academic courses and even a university dedicated to economics, as well as a number of organizations producing statistics. Although the team was not able to perform an in-depth analysis of their capacity, interviews and research indicate that there is still much to be done before the country achieves self-sufficiency in these disciplines. Several marketing organizations are effectively applying market principles and providing strong research and survey capacity, but they are not enough to support the needs of the Government or private sector in ensuring better competition law.

There is a complete lack of professional organizations dedicated to competition law. Judges and lawyers are not organized around these themes, nor are any business associations or consumer advocates addressing them effectively. This is not surprising for two reasons. First, Azerbaijan's progression to a healthy civil society is quite slow and has no historical model to work from. Virtually all Azerbaijanis living today in Azerbaijan grew up under command political and economic models. Second, competition law, even where it is promoted vigorously (such as in the United States), is often misunderstood or negatively influenced by entrenched interests. Growth in this area will take time and, most likely, outside technical assistance.

5. The Market for Competition Law Reform

Demand for reform is not only diffuse but also effectively counterbalanced by entrenched interests who influence the Government. The de facto monopolies are known to be politically connected and rumored to use their connections extremely effectively to suppress competition and concentrate market share in their own hands. There appears to be very little political will to create an environment in which competition can flourish, at least within the economically significant sectors of the economy.

As with other areas of law covered by this report, there is little organized demand for change through private sector associations, NGOs, or other groups. President Aliyev held several "town hall" meetings in late spring to hear the concerns of foreign and local investors, who complained

heavily of problems with licensing, which is used at times for anticompetitive purposes. This very useful dialogue does not, however, represent any organized or formal system for bringing the needs of the business community to the Government, nor does it sufficiently permit effective communications of the many needs, including the need for a more open, competitive environment. Current supply and demand for reform demonstrate a market that is not functioning effectively.

F. CONTRACTS

1. Legal Framework

a. General

The overwhelming view of interviewees was that the legal system was ineffective and that rights granted by law were irrelevant nullities. Taking disputes to court takes a long time, bribes are necessary, and the final decision is subject at any time to telephone law.

Although the provisions of the formal law in general appear to be satisfactory, it is important to recognize that in virtually no case do they have independent force. Contract law was described by one interviewee as "meaningless." If a court decides an issue in conformity with governing law, no cause and effect relationship should be inferred. The cause will be perceived, in most cases, to have been a bribe or a telephone call. All the scores should be read with this caveat in mind.

While the formal legal framework appears by and large satisfactory - at least compared with actual practice - it is by no means perfect. Many laws were apparently copied directly from Soviet law, without recognizing that such laws were intended to be supplemented by legislation in the individual republics. Thus, some laws are too general to be readily applied in practice.

b. Contract Formation

The elements of an enforceable commercial contract are adequately spelled out in the Civil Code, as are remedies. One interviewee expressed dissatisfaction with the Code's provisions on damages, but they do not appear to be inadequate on first reading them. They clearly allow, for example, recovery of lost profits (see Art. 21).

While one lawyer interviewed stated that the Civil Code does not distinguish between business and commercial contracts on the one hand and contracts between individuals on the other, this appears to be true only at the most abstract level. At the level of procedure, the Civil Procedure Code establishes an entirely different court system - the Economic Courts (successors to the Soviet-era arbitrazh courts), for all disputes solely involving legal persons and registered individual entrepreneurs acting in that capacity. All disputes in which at least one person is an individual who is not a registered entrepreneur acting in that capacity are heard in the general court system. (Both court systems are subject to a cassation appeal to the Supreme Court on matters of law only.)

At the level of substance, the Civil Code in fact distinguishes between commercial contracts between businesses and noncommercial contracts in several places. For example, Art. 420 deals

with standard terms in contracts where one party is an individual not an entrepreneur, and Arts. 614 to 626 deal expressly with retail sales.

c. Remedies and Enforcement

The Civil Code provides the standard remedies for breach of contract, including liquidated damages. A court may lower the amount of liquidated damages, however, where they are considered too high (Civil Code, Arts. 462-467), thus permitting the court to rewrite the contract. This potential protection against unequal bargaining power can also be misunderstood and applied without respect for the underlying business reason or cost structure established by the parties and the market.

The law also spells out what could be a fairly effective way of seizing assets prior to judgment and then levying on those assets should the defendant (if the losing party) fail to pay the judgment. The law does not clearly balance, however, the understandable desire of the plaintiff to ensure that the defendant's assets are not dissipated or hidden while the trial is going on against the equally understandable desire of defendants not to have their assets seized before they have had a chance to answer the plaintiff's assertions in court.

Under Article 458 of the Civil Procedure Code, foreign judgments will be recognized and enforced in cases in which a treaty with the foreign country is in question, or in cases in which the courts of the foreign country in question enforce the judgments of Azeri courts. The same principle applies to foreign arbitration rulings. (Azerbaijan is a signatory to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards.) In either case, review by the Supreme Court is required, suggesting that the Supreme Court could overrule or modify the initial findings rather than simply enforce the judgment. Respondents noted that, in practice, Azeri courts do not respect foreign arbitral awards and regularly substitute their own judgment for that of the arbitration tribunal.

d. Definition of Implementing and Supporting Institutions

It appears (although not with absolute certainty) that laws and regulations must be published to come into effect. Laws passed by Parliament are published in the newspaper *Azerbaijan*. Decrees of the President and orders of the Cabinet of Ministers are published in a separate publication, the *Presidential Gazette*. Finally, normative acts issued by ministries must be submitted to the Ministry of Justice for review and subsequent publication in the Ministry of Justice's gazette. (There was some confusion among local legal professionals, however, regarding whether publication review and publication were required for ministry regulations and decrees.) In short, an individual could have access to all valid laws and regulations by obtaining copies of three publications.

Article 13.1 of the Civil Procedure Code states that judgments must be made on the basis of laws, decrees, and other normative documents but does not spell out a requirement of publication. The law also requires that court decisions be in writing and that they set forth the basis for the decision (Civil Procedure Code, Arts. 219.1 and 220), but in many cases in practice the decisions contain no real reasoning that could be used for improved understanding of the law or as a basis for appeal.

2. Implementing Institutions

The principle implementing institution for contract law is the court system. Under the recently revised methodology, the court system covered more fully under the separate heading of Commercial Dispute Resolution, and is not covered in detail here. However, several points specific to contracts are discussed in this section.

First, enforcement of contracts through the courts is sporadic, at best. Most respondents addressing the issue felt that judgments are unenforceable, and, by extension, so are the contracts that serve as the basis for the judgments. This situation hinders the development of contract law through consistent interpretation and enforcement of contract provisions. Even without the common law use of precedent, developed civil law countries rely on the doctrine of consistency to ensure that courts interpret law in a similar manner, thus refining understanding and practice of contract law. Azerbaijan's courts do not provide a foundation for such growth at this time.

Second, winning judgments are considered to be a matter of influence or bribery, not law. Even though respondents consistently reported that they believed that judgments were unenforceable, the fact that there is ongoing use of the courts, and that defendants respond to a reputably unenforceable system, suggest that losing in court has negative consequences. Lawsuits seem to be a contest between the parties to obtain the favor of the state. Respondents universally reported their belief that winning a lawsuit was much more a function of bribery - with the decision going to the highest bidder – or the one with the most influence - with judges receiving phone calls or balancing the relative political importance of the parties. Either way, the courts are not respected for their jurisprudential value, which undermines the importance and sanctity of contracts.

3. Supporting Institutions

a. Government Entities

Notaries present something of a problem in the formation of contracts. As with other Azeri legal institutions, the notarial system is perceived to be thoroughly corrupt, with a scale of unofficial fees that appears more or less to track the scale of official fees. Notary fees used to be very high, and this discouraged the formation of various types of contracts (in particular, small-scale

lending). Recently, however, the official fees were lowered and now are considered fairly reasonable, but the addition of unofficial fees still affects the overall cost structure of lower value transactions.

For many types of transactions, notaries enjoy a monopoly within their designated geographical area. In other countries, similar monopolies have resulted in lower quality service, higher costs, and potential abuse of power against disfavored parties. In Azerbaijan, there appears to be no formal system of accountability or discipline for notaries, but legal responsibility for damages for failure to perform their functions properly does act as a check on poor work. (Several respondents cited cases in which notaries were in fact compelled to pay damages for failure to pass clear title.)

Interviews with a variety of notaries indicated that their most important functions in the areas of contracts were in sale of real property and issuing powers of attorney for automobile use. In real property, they are responsible for ensuring that the contract is correct, explaining the consequences and implications of the contract to the parties, and ensuring that title is good. Notaries have effectively standardized much of the documentation for these transactions and are generally perceived to be competent in this function. Indeed, as noted in the section on Real Property, they are the gatekeepers of good title.

Powers of attorney for automobile use illuminate breakdowns elsewhere in the legal system. Theoretically, the sale of an automobile should be a relatively simple transaction that is registered with the police and becomes immediately effective upon registration. In at least some parts of the country, however, the cost (due to bribery) and the complications of sale are such that parties are using the power of attorney for the sale of the use of the automobile instead of the sale of the automobile itself. With no hope of reforming the system, individuals, with the help of the notaries, have found a way of getting around the system - the seller (although of course not called that in the contract) for a price agrees to grant the buyer full use of the automobile. Although the seller formally retains title, ownership has in substance passed to the buyer.

b. Bailiffs

Bailiffs appear to have sufficient authority to enforce judgments but will not use that authority unless appropriate extra payments have been made. Numerous interviewees noted the ineffectiveness of courts in enforcing judgments.

c. International NGOs[19]

ABA/CEELI is engaged in a number of projects that support the development of contract law. As noted above, it sponsors clinical programs at two universities that work in part in support of small business and contract enforcement. It also maintains a legal resource center that logs about 1,700 visits per month from law students and others. The center has eight Internet-connected computers, a library, and access to a commercial database of Azeri laws. ABA/CEELI also puts on seminars about twice a month on legal subjects and appears to have a good group of speakers. These seminars are attended by lawyers but not by judges, who apparently do not deem it appropriate to mix with lawyers in this fashion.

d. Professional Associations

Lawyers (broadly defined) can be divided into three groups: the approximately 500 members of the College of Advocates (essentially, Soviet-era lawyers who operate mainly in criminal cases but for whom a special role in cassation appeals is reserved by the Civil Procedure Code), the approximately 200 or 300 lawyers registered with the Ministry of Justice, and lawyers not registered with the Ministry of Justice who provide legal services and represent clients pursuant to a power of attorney signed by the client and authorizing such representation. It is not clear what benefits follow from registration, but apparently there are some, because many lawyers are willing to undertake the arduous and obstacle-ridden registration process. Advocates seem to have little involvement in commercial matters and are viewed generally as a conservative group with a deeply vested interest in the status quo. A Law on Advocates was recently passed in an attempt to unify the legal profession, but apparently it is not in force.

There are currently two associations of legal professionals: the Azerbaijan Young Lawyers Association, which includes law students, and the Azerbaijan Lawyers Association (ALA). Both are very small and have no political clout. ABA/CEELI is now working to set up a voluntary lawyers association that will have a much larger membership and that will act as a counterweight to the College of Advocates. Apparently the ALA is not currently perceived as the appropriate vehicle for this.

Although bar association activities were characterized by one interviewee as "nil," the ALA has sponsored the publication of several books and materials for university law teaching. The team was informed by the ALA that demand is high for the publications they have sponsored because there is very little published in Azeri on Azeri law. Legal professionals must still rely on old Russian materials. In spite of ALA assertion that demand for publications is high, the demand

[19] International donor programs are not appropriately characterized as supporting institutions because their existence is usually a result of a gap in the national supporting institutions. The team has included the ABA/CEELI program here, however, for reasons of convenience and because it is the only program of its kind to fill gaps that should be covered by local organizations.

appears to be low, because the market for legal information apparently does not support the publication of such materials, and they would not appear unless subsidized. The ALA itself receives only symbolic dues from its members and is funded almost entirely by international donor agencies. Thus, ALA appears to exist as a response more to foreign needs than to domestic ones.

The ALA has also put on a limited number of workshops for students and young lawyers. Participants receive a certificate stating they are qualified to teach courses in commercial law.

There is no significant nongovernmental input into the drafting of legislation. The new Civil Code of 2000, for example, was initially drafted at government request by German specialists. It was then handed over to a commission composed of representatives from different sectors of Government, including the Presidential apparatus, the Parliament, the Ministry of Justice, and the Supreme Court. This body worked on the draft for about 3 years before it was finally presented before the Parliament for passage. The Parliament dutifully passed this and three other codes on the same day. At no time in the process was there any involvement of non-governmental groups such as legal research centers or academia, NGOs, bar associations, trade associations, or chambers of commerce.

The team was informed, however, that the ALA had in some cases received copies of draft laws not related to the Civil Code (relating to lawyers, the judiciary, NGOs, and the registration of enterprises) and had offered advice, which was not always taken. This is indicative of the ad hoc approach to involving NGOs and other private sector interests in the legislative process. The ALA has been given the opportunity to review some drafts but has no right to obtain and comment on laws based on an open and transparent system in which drafts are published for comment. ALA did not have any input into the Civil Code.

e. Specialized Services

Repeated questions to several different interviewees yielded a consistent answer: there is no arbitration system to speak of in Azerbaijan. There are persons who would be qualified to serve as arbitrators, but the practice simply does not exist.

There are several legal publishers, and legal professionals were generally quite satisfied with the availability of legislation. These same professionals noted, however, that there is an absence of treatises and explanatory materials, which are considered to be as important as the laws themselves. The Azerbaijan University Law School recently began publication of a law journal that addresses this need, but it is too early to determine how much of the demand for materials will be met by this publication. Likewise, the ALA has published a treatise on Azeri law, but much more is needed.

f. Trade and Special Interest Groups

There are two associations that can be viewed as chambers of commerce. The first, the Azeri Chamber of Commerce and Industry, is a holdover from the Soviet era. The second is the Azerbaijan Confederation of Entrepreneurs. The business community apparently usually looks to itself for solutions to its problems; people are unwilling, in the words of one interviewee, to stick their necks out.

At one point there was one newspaper, a weekly called *Femida* that was aimed at lawyers and to a lesser extent the general public and that covered legal matters. It was, however, closed by a court order after it offended the prosecutor's office and a particular judge in Baku in two articles.

AmCham is actively lobbying for better Azeri law and has recently refined its strategy to pursue change on an issue-by-issue basis, having found that its white paper covered too many topics to be effective. The response of foreign businesses to inadequate legal provisions is often simply to provide for foreign law and arbitration in their contracts.

g. Standard Form Contracts

Standard form contracts are not generally developed by the business sector in Azerbaijan. The Ministry of Justice has developed several forms for contracts that must be notarized, and these forms are apparently available at notary offices. Such forms are commonly used, for example, for the purchase and sale of housing. While use of the forms is not mandatory, clearly it is prudent, given that the notary reviews the contract for substantive compliance with law and will demand higher fees for review of a nonstandard contract. The Ministry does not supply standard forms for contracts that do not have to be notarized.

It was indicated during an interview that the central bank has created standard form contracts for certain kinds of secured lending, and the Cabinet of Ministers has approved certain standard form contracts for employment.

There is no indication that organizations such as chambers of commerce or professional associations develop standard form contracts for their members' use. Small businesses typically rely on oral agreements and would go to a lawyer were a written contract desired.

One lawyer interviewed stated that he used books in German and Russian that contain standard form contracts. There is also a commentary on commercial law published by the ALA that contains some standard form contracts. While the demand for free copies of this book appears to be high, few lawyers have been willing to pay the $5 purchase price, suggesting that its practical usefulness is limited.

h. Legal Education

Azerbaijan has virtually no specialists in commercial law. At present, there is apparently not one doctorate holder in the field of commercial law in Azerbaijan, and there are only three in civil law as a whole. Most LLB graduates go to work in Government, for example in the prosecutor's office, and are not interested in commercial law. Within the last several years, there have been no graduate students in civil or commercial law, according to one interviewee, who noted that to be a graduate student in law, an individual must be close to the President's family.

Curricular reform is needed in the law and business schools of the country. Company and securities law are dealt with either summarily or not at all. Commercial law and civil law generally receive somewhat more attention, but it appears that the law school curriculum has not caught up with the transformation of Azerbaijan's economy from a socialist planned economy to a market economy (in principle).

ABA/CEELI supports clinical programs at the law faculties of Azerbaijan University and Azerbaijan International University, both private institutions. These programs currently train about 25 law students. Until recently, students represented individual clients in civil cases. The programs were recently expanded to allow students to represent small businesses that cannot afford representation. The business caseload includes collections, contracts, and registration issues being heard by courts. Students do not need to be qualified or registered lawyers to represent clients in court; a simple power of attorney from the client is sufficient. They are, however, in practice supervised by the clinic teachers in their work.

ABA/CEELI also runs a lecture and seminar series that includes commercial law topics. There were mixed reviews by participants on the quality of these lecturers.

i. Legal Information

About 15 monographs per year are published on Azeri legal topics. Legal publication, moreover, is largely or wholly self-funded. Some law journals are (relatively) widely read but their usefulness and quality is not clear. One Azeri lawyer interviewed stated that he did not read such journals.

The law faculty at Azerbaijan University has started an academic law journal, of which apparently the first two issues have been printed in a run of 500. It is intended to be a monthly. The team was told that this is the only law journal of its kind - contrary to other reports indicating the existence of more than one journal - and that it is read by students and distributed to the Parliament.

There is little legal literature available on Azeri commercial law. One teacher interviewed stated that he relied on Russian books for his teaching. There exists no Azeri commentary on the new Civil Code, although individual articles have been written on various aspects of it. In addition, there is an Azeri translation of a Russian commentary on the Russian Civil Code, but this is of limited usefulness.

One interviewee suggested that a fruitful area for assistance would be to help Azeri lawyers and other legal specialists to prepare Azeri-language works comparing Azeri law to German and American law, and to distribute these works free of charge to Azeri legislators and libraries. The same interviewee also proposed the establishment of a law journal, with its own Web site, publishing Russian and Azeri translations of the works of foreign specialists to increase local exposure to foreign academic thinking. While the interviewee thought that such works might be commissioned, it would seem far more feasible to develop a process for identifying useful articles already in print and having them translated.

A constant theme of discussions regarding legal information was that while there is a readership for such information, that readership does not want to pay for it. It would appear, therefore, that legal information has not yet developed sufficient commercial value. This is what would be expected in a society where legal institutions are both corrupt and weak and suggests that any payoff from improved access to legal information will occur at best over the long term.

4. Market for Contract Law Reform

a. In General

Overall demand for change in the contract law regime seems low. This is not surprising, for several reasons.

First, the overhaul of the legislative framework, under way since independence, combined with the lack of education and information regarding the changes, leave most legal professionals with little basis for judging the current state of affairs. Virtually no one adequately understands the changes produced through the new Civil Code, so they do not know whether any change is needed. Indeed, when the judiciary was reappointed 2 years ago, they were tested on the old laws - many have no idea what the new code contains. There is a demand for better education and information regarding the existing laws, which when supplied may lead to a focused demand for amendments and modifications. That possibility is several years away.

Second, much, of the nonoil economy operates on a cash basis. There is very little lending, and thus very little need for contracts to regulate and define ongoing or future relationships connected to more complex transactions. Cash transactions do not require a sophisticated legal

regime. Term financing and complex transactions are prerequisites not fully in place, so that demand will also lag until opportunities to move beyond simplicity arise.

In many countries, foreign investors act as the drivers of change in the legal framework as they seek to improve the investment climate. With oil interests dominating the economy, it might be assumed that foreign oil companies would lead the push for legal reform in Azerbaijan. In fact, they are not a significant source of such demand because they are in effect subject to their own legal system through Production Sharing Agreements (PSA). The PSAs are negotiated directly with the government and then ratified by the Azeri Parliament. They therefore have the status of national law. Although the oil companies by no means win every dispute with the Azeri Government, they have economic clout sufficient enough that their disputes are resolved as a matter of bargaining power, not as a matter of legal right.

AmCham is focusing demand for change among foreign and domestic interests. At present, however, their members' needs are for improvements to the overall investment climate, rather than improvements to contract law.

Assuming demand for change, a good place to focus would be the system of supply, which is inadequate and inappropriate. The principle example of this in recent years comes from contract law and the passage of the new Civil Code. As mentioned previously, this Code was drafted with much-needed outside technical assistance but not with input from the private sector. It responded to external rather than internal demand and consequently was not structured to connect with local interests during the process.

The private sector does not generally perceive contract law, and law generally, as responsive to its needs in practice. Many government officials appear to view business activity as a potential source of personal wealth, not as a contributor to the economic health of the country as a whole and therefore as something to be fostered for that reason. In summary, there is no connection between supply and demand in the contract law arena.

There is also little local capacity for drafting needed changes. Although there are some very good legal professionals with experience in modern, market-oriented legal systems, there does not appear to be a sufficient supply of such individuals with requisite drafting skills to meet the long-term demand for change at this time. Government will continue to need technical assistance in this area for the foreseeable future.

The manner in which the laws are supplied is also problematic. No good system exists to classify and index laws and regulations within the system of legal publishing. For example, the area of secured financing is beset by potentially conflicting or overlapping legal provisions from a variety of laws, none of which reference the others. Judges, lawyers, and others must simply invent their own filing system to keep track of regulations as they are published. ABA/CEELI

reported that they expend considerable resources in cutting, pasting, and filing. There is no formal system of codification or indexing to ensure that amendments to legislation will be placed in proximity to the original legislation.

b. Market for Effective Implementing Institutions

Complaints about the court system are pervasive, but this has not translated into any sort of focused demand for reform. The business sector does not regularly use courts for contract disputes. As noted elsewhere, economic courts are used largely for disputes with the Government. Nor does the business sector use alternative third-party dispute resolution procedures, at least not at any significant level of formality. Several groups are currently working on programs for ADR, suggesting that there is substantial demand for a system of contract resolution, but only outside the Government. This will be undercut, however, if courts will not enforce the decisions of arbitrators.

The Government itself has not yet clearly evidenced any demand for better provision of contract resolution through the courts. The Supreme Court is rumored to be very resistant to change, as is the Ministry of Justice. One interviewee characterized the Ministry as operating "through fear and intimidation." Virtually all characterized it as difficult to deal with.

In general, there appears to be little political will for reform, thus it is not surprising that the supply side of reform is not functioning. There is no system in place for detecting systemic problems with the way courts operate. The Supreme Court provides some monitoring of select legal issues, but judicial behavior appears to be monitored by no one. Indeed, the judicial system seems to be mired in a culture of corruption of astonishing shortsightedness, which blocks many initiatives. There were even reports of donor programs being curtailed or eliminated because of demands for bribes by officials able to block the reform process.

Because corruption is the rule and not the exception, it is hard to imagine how there could be an effective process for improving court performance and responsiveness to litigants that did not at the same time require completely revamping the court system and probably many other government institutions as well.

The supply of improved technical capacity is no better. No system exists for continuing education for judges. Occasional seminars are offered with donor support, but neither the courts nor the Ministry of Justice appear to have any plans for the institutionalization of such efforts. At best, judges will learn the new Civil Code on an ad hoc basis.

c. Market for Supporting Institutions

It is not clear whether the business community really feels the absence of various supporting institutions. Businesses may not fully appreciate the role that can be played by such institutions. Likewise, most legal professionals have no experience with service-oriented professional organizations, but have had dissatisfying experience with government-sponsored organizations. Without awareness of the possibilities, there will be little focused demand for change.

It is also unclear whether the general absence of strong civil society institutions is due to government repression or simply a lack of social demand for them. Historically, all institutions were overseen or controlled by the state.

G. FOREIGN DIRECT INVESTMENT

1. Overview

FDI to Azerbaijan is concentrated primarily in the oil sector and as a result fluctuates with oil prices. For example, FDI to Azerbaijan peaked in 1998, reaching $948.2 million, but was $355.3 million the following year. Outside the oil sector, on the other hand, Azerbaijan attracts little FDI. Although there are a number of opportunities for foreign investors in the service industries (financial services and telecom) and agricultural businesses, Azerbaijan's unfavorable environment for FDI is likely to keep these investors at bay. The lack of a certain and predictable legal regime is one of the primary reasons why Azerbaijan is not attracting foreign investment and is also forcing many of the existing foreign businesses to close down their operations. The assessment team met with two prominent international banks with operations in Baku that have decided to terminate their investment and pull out of Azerbaijan. It was also reported that more than 150 Turkish investors withdrew their investments last year.

The problems/difficulties with doing business in Azerbaijan were summarized in AmCham's May 2001 white paper titled *Business Today in Azerbaijan*. These difficulties include -

- A legal framework that is unclear, inconsistent, and unfairly implemented
- Nontransparent and nonopen enforcement of laws
- Problems with contract law and security
- Lack of international accounting standards
- Lack of coordination among government agencies
- Lack of regional customs harmonization
- Inadequate market liberalization.

It should be noted that the unfavorable FDI environment stems not from discrimination against foreigners and their investments but rather from a generally difficult Azeri legal and institutional business framework as indicated above. Azeri businesses and entrepreneurs suffer equally from an environment that is fundamentally antithetical to business growth and private sector development, as evidenced by growth in the informal economy as entrepreneurs give up on the official system and find ways to survive in the informal market.

2. Legal Framework

The legal framework for FDI in Azerbaijan falls into two categories: the first relates to the oil sector and is governed by the PSAs; the second is the nonoil sector, which is governed by the 1992 "Law on Protection of Foreign Investments." (LPFI)

After Azerbaijan gained its independence, the legal system was inadequate to deal with the influx of major foreign investment, particularly in the oil and gas sectors. As a result, foreign oil companies negotiated the PSAs with the Government of Azerbaijan. Although secret and not divulged to the public, the PSAs are approved in the Parliament and have a "super legislative" status in that they seem to take precedence over any current or future law, decree, or administrative order of Azerbaijan. Because these documents are not public, the assessment team was unable to review or analyze one. However, it can be inferred that the oil companies have negotiated terms that provide for certain rights and protections that were unavailable under general Azeri law.

Foreign investors and companies outside the oil sector are governed by Azeri laws including the LPFI, the Law on Investment Activity of 1995, the Law on Privatization of State Property, and the August 10, 2000, Presidential Decree on the Approval of the Second Program of the Privatization of State Property. Furthermore, Azerbaijan has entered into a number of bilateral agreements that opens the Azeri market to foreign competition including the U.S.-Azerbaijan Bilateral Trade Treaty ratified in April 1995, and the U.S.-Azerbaijan Bilateral Investment Treaty signed in August 1997, which went into effect in August 2001.

The LPFI is the umbrella law governing foreign investment in Azerbaijan. It provides a number of important protections for foreign investors such as the "at least an equal treatment" to Azeri legal entities and citizens (Article 5), the guarantee against changes in legislation (Article 10), the guarantee against nationalization and requisition (Article 11), compensation of losses as result of nationalization or requisition (Article 12), and guarantees against termination of investment activity (Article 13). However, many of the provisions cited are vague and imprecise. For example, the guarantee against nationalization is protected except in cases where such foreign investment causes "damage to the people and state interest of the Azerbaijan Republic." Such damage is to be determined by the Supreme Council of the Azerbaijan Republic. It appears that the foreign investor in such cases is afforded no opportunity to challenge or contest the nationalization. There are numerous other vague and unclear provisions throughout the LPFI. The assessment team was informed that the LPFI is being revised; however, no such revisions were available for review during the team's visit to Azerbaijan.

Despite the foreign investment laws (with all their shortcomings), the ability of foreign businesses to operate in Azerbaijan is severely restricted because of "domestic" regulations and practices. The excessive and cumbersome business registration and licensing procedures serve as a control mechanism for the Government. For example, the process of registering a business with the Ministry of Justice, which employs nontransparent processes has the practical effect of screening all businesses including foreign businesses. Furthermore, many sectors are not open to foreign investors because of the state and politically connected monopolies that block outside competition.

3. Implementing Institutions

The Azeri Agency of Foreign Investments, which is the agency responsible for implementation of the LPFI, was absorbed in 2001 into the MOED. Because of this transition, the full mandate of this agency is not clear. Members of the assessment team attempted on numerous times to meet with the officials from this agency but were unsuccessful. This was rather surprising because foreign investment agencies are usually all too eager to meet with our assessment teams to explain the attractiveness of their countries for investment.

Foreign investors, however, have to contend with multiple state agencies. As mentioned above, without a business registration license from the Ministry of Justice, a foreign investor cannot establish a legal entity in the country. Once this significant hurdle is overcome, a business will require further licenses from another government agency to operate the business. According to some sources, there are more than 400 different types of licensing activities. The excessive nature of the business licensing requirements in Azerbaijan was a complaint that was uniformly expressed by those interviewed in connection with this report. Furthermore, many of the government agencies appear to operate in a totally closed and arbitrary matter. One foreign business recalled how the tax authorities attempted to shut down its operation allegedly for violating domestic regulations and then for refusing to pay bribes to the tax officials.

4. Supporting Institutions

With the exception of the AmCham of Azerbaijan, there are no other organized foreign investor groups. This appears to be the case for two reasons: the first is the generally low number of foreign investors in Azerbaijan, particularly from the Organization of Economic Cooperation and Development (OECD) countries; the second reason is the difficulty in establishing and operating a nongovernment organization. The Government does not seem to encourage or promote the establishment of such organizations, and the law is not supportive of this kind of organization. As a result, the AmCham is practically the only voice in the country that monitors, analyzes, and critiques government policies with respect to foreign investors.

5. Market for Foreign Direct Investment Reform

Demand for reform of the foreign investment climate is quite different from other areas of law. Unlike domestic investors, who are essentially captive (but who might also invest abroad), foreign investors do not generally look for investment opportunities in a particular country, but seek opportunities among countries. If one country does not have an attractive climate, they do not demand change, they go to another country or forego investment altogether. Demand for

change can be seen as much in the absence of foreign investors as in the position papers of foreign investor associations.

It has become a virtual mantra in the investment community that investors seek predictability, certainty, and stability. They balance revenues, costs, and risks to ensure a return on investment sufficient to justify their involvement in a particular country or industry. In Azerbaijan, the cost and risk factors are stunting investment in general, and foreign investment in particular. With promises of a significant upsurge in oil investment in connection with a pipeline, it is important for Azerbaijan to reform the climate to attract and capture additional investment likely to be drawn by ancillary opportunities. It is not clear that such reforms are under way.

As noted above, the investment climate is equally bleak for both foreign and domestic investors. Herein lies the problem - foreign investment is a subset of all investment and depends in the first instance on demand of local investors for an investor-friendly environment. Foreign investment is strongest where local investment is strong. Two examples are instructive in this regard.

The United States has the highest absolute level of foreign investment in the world, and the highest domestic investment. This is not due just to the size of the market but also to the environment. Sub-Saharan Africa, which has a larger market size in terms of population and natural resource base, has much lower investment but the highest return on foreign investment in the world. Whereas foreign investment in the United States generally brings 10 - 20 percent returns, in Africa the returns are often well in excess of 50 percent.

This apparent distortion is due to risk. Only high-risk investors dare to put their money in the unstable economies of Sub-Saharan Africa. Most of the risk is governmental - changing policies, uncertain legal regimes, unpredictable enforcement, unfair local treatment - and governments often rely on tax incentives and other gifts of public resources to attract investors who would not otherwise be willing to gamble their money there. The region lacks a healthy base of small and medium enterprises to support economic growth and development, and to support foreign investment.

Azerbaijan is currently closer to the African model of investment regimes. Extractive industries are attracted by the geographic availability of oil and other minerals, in spite of the investment environment, and have the economic and political clout to carve out their own environment. Other foreign investors are few, and possibly becoming fewer.

The driving force for change in some countries is a progressive government that recognizes the needs of investors and seeks to supply them. This is one instance where supply side economics can work quite well, because it allows local investors to flourish, which in turn makes foreign investment more attractive. Unfortunately, there is no indication that the Azerbaijan Government has a critical mass of reformers willing to create the proper environment. President

Aliyev has begun to reach out to the local and foreign investment communities, which is a sign of great hope, but much more must be done to change the current climate.

The Government will need technical assistance as it attempts to meet the demands of investors. Existing laws affecting the environment, though clearly well intentioned, are not sufficient. As noted throughout this report, there are large gaps in the legal framework, and serious problems with implementing institutions. Well-meaning reformers, such as the Committee on Securities, do not have the internal technical expertise necessary to meet their reform mandates.

In summary, the market for reform of the foreign investment environment is dysfunctional. Demand is stunted by the absence of domestic investor associations fighting for an improved investment regime. Although the AmCham very effectively articulates the needs of foreign and domestic investors, one voice is not enough. On the supply side, there is a lack of sufficient expertise to meet the overall challenge of reform, and, more seriously, there is doubt about the depth of political will for creating an environment where private investors can prosper.

H. REAL PROPERTY

1. Overview

Azerbaijan has established basic foundations that permit the sale and development of real estate through granting of private property rights and private property to its citizens. The overall property rights regime, however, is still somewhat weak and unproven and is unlikely to support rapid growth in development needed in the coming years.

The urban real estate market of Baku has been steadily developing since independence and on the surface appears to support substantial growth and development. The legal framework, however, has not developed to support real estate financing for the increased growth that is currently needed, much less the additional increases expected through growth in oil industry investment, including the expected immigration of thousands of new foreign oil employees in the next few years. Issues of title, though technically covered by the law, still haunt developers and purchasers, reducing the size and pace of investment.

The rural land regime is both simpler and more complicated. Since independence, the government has effectively privatized more than 90 percent of agricultural land but did so by granting small, scattered parcels that are difficult to farm efficiently. Small farmers have not yet developed any system for trading, buying, or selling their plots to create more efficient holdings. Mortgages on agricultural land are permitted, but only in support of agricultural activity. The mortgage market, however, has not developed because there is no significant market for the underlying land itself; a foreclosing lender simply cannot sell repossessed land to anyone.

Registries for land and buildings work sufficiently to meet current demands. Land and buildings are registered separately in separate government registries, so that there is no harmonized cadastre and registry, but the market does not seem to care at this time. Harmonization and unification will be a goal for the future, especially for urban land. The more important short-term need is in clarifying ownership rights and reducing confusion over the many overlapping laws in this area.

Supporting institutions are quite limited, consisting primarily of notaries and a few competent real estate services. Notaries act as the gatekeepers for the system, protecting title and ensuring legitimacy in transactions. For the most part, they are functioning effectively in this role, but the costs are unnecessarily high. It is also not clear whether they are prepared for any significant increase in market activity.

As to real estate services, there are a few very sophisticated real estate agencies providing reliable services in Baku, but they are competing with a number of much lower priced "cell phone" realtors who purportedly have no offices and limited professionalism. Better regulation

is needed to protect the public, which will require changes in the current licensing regime and might best be operated through a self-regulating real estate organization, but no such organization yet exists. Market information is not yet organized through any centralized listing services.

The highest demand for reform among stakeholders is in the enforcement of property rights. Most users are generally satisfied, or at least not unduly concerned, with the overall legal regime, but do not feel that the courts effectively handle property issues when a dispute arises. This problem has been noted throughout this report, suggesting that reduction of the use of courts through better definition of the law will be the first step, while greater resources are employed to address the fundamental reform issues within the judiciary.

2. Legal Framework

The laws covering rights in real property are found primarily in the Constitution, the Civil Code, the Land Code, and the 1998 Law on Mortgage. The Constitution establishes the basic right of Azerbaijan citizens to own private property without confiscation by the state, other than in exceptional circumstances of imminent domain, and then only with proper compensation.

a. Ownership.

Although the law framework clearly grants ownership to the citizens of Azerbaijan, these rights are not extended to all. Foreign individuals and foreign corporations are not permitted to own land outright. They may lease land and other property under long-term contracts with no legal restrictions on the length of the lease. However, this apparently restrictive approach is hollow. Foreigners may incorporate Azerbaijani companies as 100 percent owners, and the company will have full rights to purchase and own land without regard to the share ownership. As a result, the apparent restriction on ownership becomes nothing more than a tax, with foreigners having to pay for incorporation of a local holding company instead of being permitted more straightforward property rights.

For those who can own land, the law permits ownership in common, whether by several owners, such as family members receiving through inheritance, or by a commercial organization of individual owners such as a condominium. The law defines rights and obligations relating to common spaces for condominium arrangements but also permits variations of these terms by contract between the parties. For the near future, these aspects of the law are sufficient to support both the existing and a growing market in real property.

In some countries, the right to private ownership is undercut by a lack of privatized land. This is not so in Azerbaijan, where more than 90 percent of agricultural real estate and more than 50 percent of urban real estate have been privatized to date. Individuals and corporate entities do

own real property and occasionally even buy and sell it. Ownership of property is treated separately for land and buildings, however, leading to some interesting ownership structures in Baku.

Buildings and land are privatized separately, not as a unit. The owner of a building has rights of egress and access over the underlying land but does not actually own the land. However, a building owner does have the right to privatize the land, and in the event someone else wishes to privatize it, the building owner has a right of first refusal to purchase it at the official, low price. In practice, owners of buildings are often satisfied with the rights over land inherent in the building purchase and do not bother to privatize the land at all because it is not necessary for their existing needs. One real estate developer stated frankly that it was simply not worth the hassle of going through the privatization process, because no one else could claim the land once the building was purchased, and there was no need to purchase it unless the developer wished to build something new on the land. In practice, therefore, privatization of urban buildings has become more important than privatization of the land on which they are built.

b. Transfer

Ownership includes the right to transfer by sale, gift, exchange, or inheritance, and all are used. They may exercise this right without seeking permission from a government official and may negotiate the terms of transfer freely through private contract. Ownership is transferred at the moment of registration, which can take several months, but is protected in the interim by the notarial and registry system. Under this system, the registry produces duplicate original certificates of ownership, of which one is kept in the appropriate registry and the other by the notary performing the transaction. These certificates are submitted to the registry for cancellation and reissuance to the new owners and cannot be tampered with once filed, absent deliberate fraud and collusion between registrars, notaries, and the owner. Thus, the well-established transfer practice precludes any serious threat of fraudulent sales between closing of a real estate contract and registration of the contract with the proper registry. Real estate professionals (including lawyers, notaries, registry clerks, and realtors) did not perceive a significant threat of fraud in this area.

The only significant weaknesses in the system come from practices related to “hidden” liens and practices related to joint ownership. The hidden liens occur because all registered occupants of a building have a claim on the sale of a residential building or apartment and must give their consent to the sale, even if they are no longer residing there. This right arises from prior laws and tradition, because the current law seems clear that only registered owners - not registered occupants - need to be involved in the sale of the property in question. Even so, real estate professionals are very careful to obtain the signatures of all registered occupants, except for those who have moved for an “indefinite” period, and are thus deemed to have abandoned occupancy claims. Consequently, purchase of a residence can require difficult searches or delays

associated with getting the signatures of registered occupants who may have moved away for studies, a period overseas, or military service. This could be rectified through public education and enforcement of the existing law, that is, disallowing claims by anyone not registered as an owner. In the meantime, some buyers are requiring the deregistration of all non-owners before they are willing to buy.

Ironically, one of the most poignant examples of this problem was encountered when the assessment team arrived at the American Embassy for their final debriefing. The team was met by a group of protestors who evidently appear daily to complain that they were not properly paid for the space now occupied by the Embassy and USAID Mission. According to unofficial accounts, the problem arises from the transfer of these buildings from the Government of Azerbaijan upon negotiation and payment by the United States. The Government of Azerbaijan purportedly received payment for the buildings (presumably still under state ownership or else condemned under doctrines of imminent domain for state purposes), paid and evicted the occupants, and turned the property over to the United States. When the evicted occupants complained that they had not been paid enough, they were instructed to take it up with the new occupant and have now been protesting for several years about their "wrongful eviction" and alleged underpayment.

Whatever the actual facts of this transaction, the fact that the Government of the United States could not get a clean, effective transfer of property rights sends a very strong and disturbing message to lesser powers. In the process, this uncertainty lowers property values as well.

The other significant weakness comes through the tradition of permitting the husband to close the real estate transaction without the presence of his wife in the sale of jointly owned property. Several real estate professionals reported cases in which a husband had sold joint property to a buyer, using a letter from his wife indicating her agreement to sell, which is apparently a very common practice. After payment was made, the wife discovered the sale and successfully sought to nullify it, claiming that her signature was a forgery. The buyer then lost the payment for the property, which the husband had already spent or moved elsewhere, and lost the property. While there are certainly various legislative approaches that could be used to rectify this problem, the simple solution is for buyers to protect themselves by requiring the physical presence of all registered owners at closing.

Although some of these traditions may be based on gender roles and traditional authority structures, the law is adequately gender neutral. Both men and women may own property in their own names, may buy and sell independently, and may bequeath and receive bequests. Property purchased before marriage by one of the parties belongs to that party alone, and property purchased during marriage is jointly owned. There seems to be very broad acceptance of these rights, even in divorces.

c. Registration

The law provides that ownership (title) passes at the moment of registration, not simply at contract. Delays in registration, however, do not create any significant risk of loss or fraud resulting from the existing system of notarial involvement and submission of documentation, as described above. Registration can be made of interests, claims, transfers of part or all of a parcel, and mortgages. It is possible for interested parties to obtain information, but this often requires payment of both official and unofficial fees.

Registration is not unified. That is, land is registered separately from buildings, and in a separate registry. Moreover, the place of registration differs inside and outside of Baku, as follows:

	In Baku	*Outside Baku*
Land	Mayor's Office	State Land Committee
Flats or Buildings	Bureau of Technical Inspections	Bureau of Technical Inspections

In addition, nonprivatized land or buildings are not registered in any of these locations until privatized, with information available through the Privatization Agency. This multiplicity of registries increases costs and delays in real estate transactions but does not currently have any significant impact on the overall market. Future centralization and unification, especially through computerization, is highly desirable but is not a priority for the market at this time.

d. Mortgages

As noted in the chapter on collateral, secured lending is covered by the Law on Mortgages and the Civil Code. No separate body of law on real estate lending exists, nor do these laws generally distinguish between types of property under pledge. In addition, there are no implementing regulations or treatises on any of these laws.

Stakeholders note that the newness of these laws and the overall legal regime is a greater problem than any particular gaps or weaknesses in the laws. Many professionals do not have a firm grasp of mortgage lending and its implications for borrowers and lenders. Laws relating to secured lending have changed significantly three times in the last 8 years. The Civil Code has improved the legislative framework, broadening the secured lending possibilities, but this law is only 1 year old, and the market has not had time to adjust, absorb, and use the new possibilities.

Real estate professionals and lenders, for the most part, are not nearly as concerned with the legislation as with enforcement of rights and the existence of a market for various types of transactions. The Land Code unnecessarily restricts the use of secured credit on agricultural and

agricultural improvements, but none of those interviewed raised this as a problem. One lender noted an "insatiable demand for credit" in rural areas, for which mortgage lending was not a solution. Although this lender does issue mortgages, land is valued at zero for accounting purposes.

The problem with rural mortgages is that ownership is as much a matter of tradition as of law. Repossession of property leaves the lender with property that no one will buy when it involves involuntary transfer, because in the local tradition it continues to belong to the defaulting borrower. Lenders have turned to various forms of moral suasion and nonland collateral instead of outright mortgages.

There is one exception to this rule. Outsiders and even local neighbors will purchase land that has been developed with export tree crops such as hazelnuts. This makes sense in light of the current agricultural plight of Azerbaijan. Most farmers are doing little more than subsistence farming, producing well under the proven, historical capacity of the land. Subsistence farming, especially in annual crops, seldom supports investment borrowing, and these agricultural parcels - especially when small and disparate - are not particularly attractive to potential buyers. Orchards, on the other hand, represent productive investment with future returns at minimal labor and are very attractive in the local market. They would become even more valuable if producer prices were not suppressed through anticompetitive restrictions in the export market.

Urban land and buildings do not suffer from the same problems as the rural market but suffer from an equally serious problem - the lack of enforcement. Numerous respondents complained that enforcement of mortgage agreements was exceedingly difficult, especially when it involved eviction of residents. Because of this enforcement gap, the threat of eviction does not serve as a sufficient incentive for making payments, and it is difficult for lenders to manage their risks. It is therefore not surprising that real estate purchase and development is primarily self-financed.

In the cases where lenders have been able to enforce mortgages, they run into a different problem. Upon sale of the mortgaged property, they have to pay VAT of 27 percent on the amount of the sale, thus substantially raising the cost of collection. This particular tax should be revisited and revised if the government wishes to create an environment conducive to the growth of secured lending.

e. Land Use and Zoning

There appears to be no zoning authority or city planning agency that develops or enforces strategic zoning restrictions. Respondents noted that zoning was limited to industrial and non-industrial, with industrial enterprises permitted to operate only in certain parts of the city.

An informal system of zoning appears to be practiced, however, through the issuance of building permits, licenses, occupancy and safety permits, and the like. Real estate developers in Baku must have plans approved by the city architect, who has substantial discretion and can theoretically disallow plans. Likewise, licensing authorities can prohibit certain activities at the intended location by refusing to grant a license. There is no rulebook, however, to limit or guide such discretion; there is, however, much dissatisfaction with the level of bribes, "grease" payments, and other rents by the authorities in the relevant agencies. It should be noted, however, payments demanded for approval of architectural plans are reported to relate only to timing of approval, not substance. Several real estate professionals noted that the plans are effectively analyzed to ensure compliance with earthquake and other codes but cannot necessarily be obtained in a reasonable time frame without unofficial payments.

f. Taxation

In Baku, property taxes on buildings are based on square footage, not on market value. The tax is universally accepted and considered an unimportant cost. Other taxes, however, are based on the sales price of property, and the market has responded through very common practices of understating the value in sales contracts to avoid higher taxes.

g. Conclusions

The legal framework for real property is reasonable for the time being, although far from perfect. The newness of the various laws, their overlapping provisions, and the lack of experience with the laws create an atmosphere of uncertainty and confusion, best addressed through initiatives to clarify property rights and train real estate professionals in the new legal framework.

The greatest threat to development, however, is not in the law. Two international banks have closed operations in Azerbaijan because the overall commercial climate does not permit them a reasonable level of profitability to stay. Securing loans with mortgages does not sufficiently reduce risks to justify the high costs of attempting to do business. Without credit available for real estate, the development will be hobbled and entrepreneurship limited. Changes in enforcement, taxation, high transaction costs of excessive registration and licensing, and ever-present problems of corruption all stand in the way of real estate development, even under existing law.

3. Implementing Institutions

a. Registries

Azerbaijan has three separate institutions in charge of registration of real property. All buildings (industrial, commercial, or residential) are registered with the Bureau of Technical Inspections. Rural land and regional urban land are registered with the State Land Committee in the district in which the land is found, and urban land in Baku is registered at the mayor's office.

From a user standpoint, the work done is generally satisfactory. Users perceived that the various registries were competent and trustworthy, with registrations taking place within a reasonable time frame. Indeed, timeliness was not particularly important for purchasers, because the certificate of ownership and the notarial system tend to ensure that there will be no real threat to ownership even if registration is delayed. Several respondents noted cases in which buyers might wait for months before even registering their purchases.

The team was able to visit the land registry office of the Mayor's Office of Baku and found the staff to be well trained, highly knowledgeable, and surprisingly service-oriented. The principle respondent had copies of laws, forms, and regulations ready at hand and referred to the legal provisions covering various topics. This matched reports from various lawyers and realtors, other than one who mistakenly assumed that the clerks would not even speak with us because of suspicion or fear. For a paper-based system under the current level of market development, the registry seemed properly and sufficiently staffed.

Although all government agencies were accused of corruption or rent-seeking by at least one respondent, accusations regarding the registries focused on "expediting fees" for performing tasks in a more timely manner. Even then, the costs were generally considered reasonable, constituting more of a nuisance than an impediment. Inconvenience was another theme, relating to the existence of separate registries for land and buildings and the impact this had on costs and delays. However, respondents did not generally complain about competence.

At the present time, there appears to be little demand or need for any significant project assistance relating to real property registries.

b. Notaries

As discussed in the first chapter, notaries serve a valuable function as gatekeepers of the real property system, ensuring good title and reducing the opportunity for fraud. All real estate contracts must go through notaries, whether for sale of land or mortgage on a building. Even though the legal rights arise at the moment of registration, the certainty of those rights currently arises at the moment of notarization.

This certainty comes at a price. The notarial system is a legalized cartel, with limits set by statute on the number of notaries permitted in any given region, based on population. Until recently, this cartel had set very high, prohibitive transaction prices for various notarial acts. The ABA and others successfully lobbied for a reduction in the fees to generally accepted levels, but the costs are still high, based more on control than on the value or expense of the functions performed.

Lack of competition for services can also lead to problems in professionalism and service quality and should be monitored. At this point, Azerbaijan is opening up the notary specialization through private notary services, which are due to begin in February 2003. It is anticipated that fees will still be set by law, but an increase in the number of notaries can lead to competition through quality of service.

Aside from price issues, and complaints that prices are often doubled in practice through unofficial fees matching the official ones, users tend to be satisfied with notary services.

c. Courts

As noted throughout this report, there is high dissatisfaction with the courts throughout the private sector and legal profession of Azerbaijan. Real property is no exception, being subject to the same complaints. Both local and international lenders are extremely frustrated with their inability to enforce loan agreements and note that this problem directly affects their willingness to make mortgage loans. Small lenders have complained that they cannot use the courts effectively and try to avoid them at all costs. Rather than reiterating the litany of problems covered elsewhere, suffice it to say that the courts are not an implementing institution in Azerbaijan, but rather a barrier to the development of real estate transactions.

4. Supporting Institutions

The gaps in civil society noted throughout this report are pronounced in the real property sector. There is no real estate association, central listing service for real estate, organized market information service, or any other coordinated private-sector association or government entity vying for an improved real property sector. Several very good real estate agencies and lawyers exist, and they provide an excellent resource for any future real estate projects, but they do not yet work together in any meaningful way. Development of some sort of real estate association will be a first step in building a base for development, both in Baku and in the rural areas.

Likewise, other services associated with real estate do not yet exist in a meaningful fashion. Some appraisal services exist, but these are nascent at best. Most valuation is done simply through negotiation and research by the buyers and sellers. Several realtors trusted their own

ability to determine reasonable market prices but not outside appraisers. Banks also tend to lack this appraisal function. Surveying is also underdeveloped, but also underused because the market is not vibrant, and much of the activity does not require surveys.

For the legal profession, there is insufficient training and education in real estate law. The law schools do not offer specialized courses in this subject, and no system of continuing legal education is yet in place to fill the gap in legal education.

The notaries and registries are currently satisfying demand for standardized forms and contracts. Much of the paperwork involved in real estate transactions and registration is standardized through practice and provided by these two implementing institutions, so that there is no great need for additional work by outside legal publishers or other groups. Further development of standardized forms can probably best be undertaken with notaries and a few real estate attorneys, which could be a valuable, low-cost project in connection with other real estate work.

5. The Market for Real Property Law Reform

The real estate market is still very immature. There is little demand for change because most transactions are still traditional, face-to-face, self-financed transactions, whether simple purchase and sale or more complex development projects, urban or rural. With the expected increase in oil investment in the regional pipeline, Azerbaijan is predicting an influx of several thousand foreigners, primarily to Baku. Normally, this would not be statistically significant in a city of more than one million inhabitants, but these new residents represent a higher level of wealth and influence and will create much higher demand for high-end real estate, both residential and commercial. It seems unlikely that changes will take place prior to the onset of this new pressure.

The ability to supply reforms is problematic. There are competent professionals in the private sector who could provide technical assistance and input, but this layer is thin. The notaries are very interested and motivated to participate in reforms but do not have market-oriented experience to draw from. Technical assistance will be needed.

On the government side, it is not clear that there is anyone available with the background necessary to draft the reforms needed. Most major changes to date have been done with significant assistance from foreign legal experts, and this is likely to be true for any real property reforms.

The greatest demand for change is not in the law. Indeed, it might be better said that there is no significant demand at all for change in the law. Demand is for clarification and implementation, particularly as regards the courts. Clarification is needed with respect to the rights of registered owners and registered occupants, as discussed above. Implementation is more urgent. Until

there are reliable mechanisms for the protection and enforcement of property rights, the many constitutional and legal guarantees currently on paper will be undercut because financing for development of real property will continue to be unavailable.

I. TRADE

1. Overview

Oil and oil products dominate Azerbaijan's trade portfolio. According to Azerbaijan Economic Trends[20] (January - March 2001), oil and oil products accounted for 64.8 percent of total export in 1998, 75.9 percent in 1999, 84 percent in 2000, and 90.5 percent in the first quarter of 2001. In addition to oil, Azerbaijan is an exporter and an importer of food products, machinery, textile, and chemicals. The major export partners of Azerbaijan continue to be the neighboring countries of Russia, Georgia, Turkey, and Iran. Its major import markets are Russia, Turkey, the United States, Ukraine, United Arab Emirates, and Germany. The United States became the third largest exporter to Azerbaijan in recent years after Russia and Turkey, accounting for about 8.9 percent of total exports to Azerbaijan.

Since 1995, the Government of Azerbaijan has embarked on a series of political, legal, and economic reforms with the aim of establishing a market-based economy and an increasing integration into the international trading system. These efforts included major trade liberalization initiatives. Yet, for numerous reasons, these efforts have not significantly increased Azerbaijan's trade outside the oil sector. Moreover, recent policy changes appear to threaten some of these reforms. (See the discussion below on the recently created Tariffs Council on Prices.) One major obstacle in the development of Azeri trade is domestic (behind-the-border) regulations. Compared with other developing countries, Azerbaijan's tariffs are rather low. It is the nontariff barriers and the excessive domestic licensing regime, however, that is hampering and frustrating domestic and international traders doing business with Azerbaijan.

Given Azerbaijan's natural resources (both mineral and agricultural), and its strategic geographic location between the EU and the other Central Asian Republics, it is natural for the Government of Azerbaijan to focus on an export-oriented strategy. However, if such strategy is to focus more than on the volatile oil sector, the Azeri Government must do more to create the commercial and legal environment that further liberalizes its trading regime and accelerates its integration into the global economy. Entering into bilateral and multilateral international trade agreements is a step in the right direction. But these agreements must be implemented and enforced within properly functioning market-based institutions that are based on the rule of law and competition.

[20] *Economic Trend Quarterly Issues*, January - March 2001, published by the European Commission, DGIA, NIS/TACIS Services.

2. Legal Framework

As previously mentioned, Azerbaijan entered into a number of bilateral agreements including the U.S.-Azerbaijan Bilateral Trade Treaty ratified in April 1995, and the U.S.-Azerbaijan Bilateral Investment Treaty signed in August 1997, which went into effect in August 2001. Azerbaijan has also entered into a Partnership and Cooperation Agreement (PCA) with the EU, which came into effect in 1999. The PCA aims at promoting "trade and investment and harmonious economic relations" between Azerbaijan and the EU. It explicitly acknowledges the desire of the parties to liberalize trade in conformity with the World Trade Organization (WTO) and provides for limited most-favored-nation treatment on trade in goods and other preferential arrangements with respect to the rights of establishments and doing business.

Azerbaijan signed bilateral free trade agreements with Russia (1992), Moldova (1995), Ukraine (1995), Turkmenistan (1996), Uzbekistan (1996), Georgia (1996), and Kazakhstan (1997). These agreements liberalize the trading relationship between Azerbaijan and the respective countries by removing tariff and reducing nontariff barriers. Most of these agreements, however, have not taken effect.

Azerbaijan has also taken the initial steps to join the WTO, including the filing of the Memorandum on Foreign Trade Regime (in July 1997) and responding to the inquiries of WTO members as part of the fact-finding phase of the accession process (in July 2000 and December 2001).

One of the brighter aspects of Azerbaijan's legal reforms is in the customs area. While the business community has expressed numerous complaints about the administration of the Azeri customs law, the customs officials interviewed by the assessment team were very open and forthcoming about the past shortcomings and current reform efforts. It seems that over the past 2 years, the Government of Azerbaijan has taken decisive steps to modernize its customs law and procedures in an effort to increase its revenue base and facilitate trade. Currently, Azeri customs is working with the World Customs Organization (WCO) on modernizing their customs laws and implementing procedures. These modernization efforts are focused on the implementation of the Harmonized System Convention, and the Kyoto Convention on the Simplification and Harmonization of Customs Procedures. Azerbaijan has already joined the Nairobi Convention on Customs Enforcement. Furthermore, according to the customs officials interviewed, Azerbaijan is also working on a customs valuations code that will be consistent with the WTO Customs Valuation Agreement. Similarly, Azerbaijan has adopted a customs code of ethics that reflects the Arusha Declaration.

One of the most alarming recent trade developments in Azerbaijan is the decision made by the Cabinet of Ministers in March 2002 to establish the Tariffs Council on Prices (the Council). According to the government announcement, this council is designed to promote the

"development of domestic production, creation of a flexible mechanism of customs duties application with the purpose of raising the competitive capacity of local products on the domestic market, ensuring tariff and rate regulations in accordance with the requirement of economic development." The Council is composed of 14 people, including representatives of chief state structures, and is chaired by the Minister of Economic Development. Although the assessment team has not been able to obtain the full text of the Cabinet of Ministers' decision, the Council appears to have been created for protectionist purposes. As the government announcement states, the Council will have the authority to impose tariffs on any foreign product to give domestically produced products a competitive advantage. Furthermore, the Council has even a broader mandate to impose tariffs in cases where the Council decides that such tariffs are needed for economic development. It is not clear how the decisions of the Council are made or whether they are appealable by the foreign or domestic business that will be affected by its decisions.

A concluding comment on the Azeri legal framework for trade: despite its international trade treaties and commitments, Azeri domestic regulatory and licensing regimes (i.e., the behind-the borders regulations) are likely to hamper any serious liberalization of trade in goods and services. Excessive licensing requirements and bureaucratic obstacles remain a major barrier to the free flow of trade.

3. Implementing Institutions

On April 30, 2001, the President of the Republic of Azerbaijan issued Decree # 475 (the Decree) reorganizing and restructuring a number of governmental agencies and ministries that implement trade laws. Pursuant to this Decree, the Ministry of State Property, Ministry of Economy, Ministry of Trade, State Committee for Antimonopoly and Entrepreneurship Support, and the Agency of Foreign Investments were liquidated or folded into the newly created Ministry of Economic Development. The MEOD was designated as the central executive agency for developing, carrying out, and enforcing state policies in the sphere of social-economic development, economic reforms, international cooperation, macroeconomics, trade, investment, regional economic policies, development and promotion of entrepreneurship, privatization and management of state property, and restriction of monopoly and development of competition. Article 10 of the Regulation of the MEOD (the Regulation) further enumerates the activities of MEOD and delineates 121 functions for which the Ministry is either responsible or has the authority to carry out or block. The MEOD's jurisdiction reaches almost all aspects of economic activities in Azerbaijan.

For a country that is trying to shed its past and move away from a command economy that is centrally controlled by a government agency into a market-based economy, the authority of the MEOD over economic activities is breathtaking and very dangerous. The Presidential Decree may have aimed at transforming the various bureaucratic agencies into a single active agency that has the authority and flexibility to promote economic development and respond to the

dynamism of the global economy. However, what was created was an agency that has wide latitude over the Azeri economy, and hence is very likely to be overly intrusive in the economic activities of the private sector and the functioning of the market. In fact, many of the functions enumerated by the Regulation explicitly allow the Minister of MEOD to intervene and to protect domestic businesses and products. For example, Article 10.33 of the Regulation authorizes MEOD "to work out measures on protection of domestic market in the Republic of Azerbaijan." Article 10.32 provides that MEOD may "apply measures of nontariff regulation of foreign trade activities, and to issue licenses for export and import operations in cases provided by the legislation."

Other articles of the Regulation can also be construed in a manner that provides the MEOD with another form of control over the economy. As an example, Article 10.29 states that the MEOD has the power "to supervise the compliance of industrial, trading, and public catering enterprises with existing norms and rules, the state-regulated prices, as well as with quality and safety of goods (except for precious metals, or precious and semi-precious stones and goods produced from them)." Similarly, Article 10.40 gives the MEOD the power "to take appropriate measures jointly with relevant state bodies, in order to protect the domestic market from import of low quality goods."

Another troubling aspect of the way in which the MEOD was established is that there is almost no check on the exercise of its authority. According to Article 11 of the Regulation, the Ministry has the power to "adopt, within the scope of its powers, the decrees that are binding for central and local executive authorities, municipalities, private persons, and legal entities." Since there is no developed body of administrative law in Azerbaijan, the regulations of the MEOD are not likely to be challenged by other ministries or agencies. Furthermore, the Regulation does not appear to provide the private sector with any standing to challenge the MEOD's decisions and acts.

4. Supporting Institutions

As was stated in the Foreign Direct Investment section of this report, the AmCham of Commerce of Azerbaijan is practically the only organization in the country that monitors, analyzes, and critiques government polices with respect to trade liberalization and international trade. Other business organizations interviewed during the assessment seemed at times to advocate "modified" protectionist policies. Beyond the business associations, however, there is little evidence that other sectors of the society see or understand the benefits of international trade.

This is one area where international donor assistance can be useful. Seminars and workshops targeted at three groups might engender a debate on trade policy. Small businesses, government officials, and academic institutions will all benefit from greater understanding of the benefits of international trade on the Azeri economy. Without such a debate, trade policy formulation will

continue to be at the highest levels of the Government with input from entrenched economic interests that have no interest in trade liberalization.

5. Market for Trade Law Reform

The demand for greater trade liberalization can be heard from different economic players ranging from large foreign and domestic companies to small Azeri businesses. The complaint is particularly acute with respect to the domestic "behind-the-border" regulations. One Azeri businessman with significant political and economic clout bitterly complained about the excessive bureaucratic and licensing procedures when it comes to importing to or exporting from Azerbaijan. He stated that importing a simple item can take up to 3 months. Inefficient, outdated, and cumbersome government regulations were uniformly mentioned as a major factor constraining trade in Azerbaijan.

The policy question that is asked is whether domestic regulations should be pursued and implemented before implementing further trade liberalization (i.e., the removal of tariff and non-tariffs barriers). As in the case of other countries, domestic reforms and trade liberalization tend to reinforce each other. Opening Azerbaijan to the outside world and attracting foreign direct investment and modern technology is likely to enhance and encourage domestic reform efforts. At the same time, opening Azerbaijan to the outside world will remain partial and incomplete unless the domestic (behind-the border) reform efforts are pursued vigorously. Therefore, domestic reforms and trade liberalization should be pursued in tandem. One key element of this continuous and circular reform process is Azerbaijan's accession to the WTO. Azerbaijan's membership in the WTO will challenge the economic status quo and the entrenched economic interests that are fighting the reform efforts, modernize and harmonize Azeri trade laws with the international rules of the multilateral trading system, and guard against the creeping protectionist policies.

A critical aspect of trade liberalization in Azerbaijan is the involvement of the private sector. Most government officials interviewed on trade matters could not cite one instance in which their agency had solicited input from the private sector. The consequence of this lack of dialogue between the Government and the private sector is that government bureaucrats who were trained under the old regime continue to make decisions about economic activities without the slightest understanding of the imperatives of market economy.