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Can Regulatory Competition Improve Contracting Institutions? A Russian Tale of Two Reforms

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Abstract

Does competition from foreign jurisdictions undermine or accelerate the development of contracting institutions? Firms in less developed countries are increasingly resorting to foreign legal institutions to safeguard their transactions. Previous research on Russia finds that businesses switch to foreign law instead of trying to improve conditions at home, impeding institutional development in Russia. An alternative prediction is offered by regulatory competition theory: When Russian businesses choose foreign law over Russian law, this could incentivise lawmakers to improve institutions. This paper examines the impact of legal outsourcing in Russia to determine which of these two effects prevails. It differentiates between two pillars of contracting institutions: the quality of the law and the enforcement of the law, i.e., the commercial courts in Russia. Two contrasting case studies of recent reform projects in both pillars are presented. The first one is a success story: Russian contract law was significantly improved and important shortcomings in comparison to English law were removed. At the same time, the judiciary suffered a setback: Incremental improvement of the commercial court system implemented by the Supreme Arbitrazh Court (SAC) was abruptly ended when the Kremlin dismantled the SAC in 2014. The paper concludes that while regulatory competition facilitates the improvement of the letter of the law, it cannot tame the "leviathan."

JEL Codes: D72, F55, F63, K12, P26

1. Introduction

Many businesses from developing countries use the laws and courts of European or North American jurisdictions to safeguard their domestic contracts for mergers and acquisitions (M&A), real estate deals and other transactions. They are able to substitute domestic contracting institutions[1] for foreign alternatives as a result of the increasing integration of less developed countries into the

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global economy, advances in information technology and falling travel costs (Morriss 2008). Fuelling the legal outsourcing[2] (Nougayrède 2013) are insufficient laws, unreliable or corrupt courts and predatory governments in firms' home countries.[3]

There are very few studies that explore the institutional consequences of legal outsourcing, the notable exception being one recent and one forthcoming publication on Russia by Gulnaz Sharafutdinova (2016; Sharafutdinova and Dawisha 2016). Sharafutdinova analyses the decisions of Russian businesses applying Hirschman's "exit/voice" framework (1970). In the early stages of Russia's post-communist privatisation, the reform architects were hoping the businesses' "voice" would lead to more secure property rights (Boycko et al. 1993). During the 1990s, however, it quickly became evident that the wealthiest Russians did not only lack an interest in improving institutions, but even benefitted from the weak protection of property rights (Volkov 2002; Sonin 2003). Sharafutdinova concludes that the availability of a relatively cheap institutional "exit" option eliminated any incentive for Russian businesses to lobby for better institutions at home (Sharafutdinova and Dawisha 2016, 17). The "exit" option – incorporation and contracting abroad – complemented illegal domestic practices in what Sharafutdinova and Dawisha call the "dark side of globalization" (2016, 3).

Against this backdrop, the research puzzle that motivates this study is a recent Civil Code reform in Russia that led to significant improvements in contract law, which is crucial for contract enforcement. The law was made more flexible and business-friendly, not least due to collective action of Russian law firms. This is in line with the idea of regulatory competition, following which economic openness and competition from foreign jurisdictions can incentivise

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1 The term "contracting institutions" is used here as in Acemoglu and Johnson (2005), where it refers to institutions that determine the enforcement of contracts between private actors. In contrast to Acemoglu and Johnson, however, this paper does not view "contracting institutions" as conceptually separable from "property rights institutions" because both depend on the court system.

2 This study adopts the term "legal outsourcing" used by Nougayrède (2013). Other papers have called the use of foreign law and foreign courts "institutional arbitrage" (Sharafutdinova and Dawisha 2016) or "rule-of-law import" (Kluge 2016). In the Russian policy discourse, it is known as "jurisdictional flight" ("begstvo iz yurisdiktsii," e.g. Kremlin.ru 2012).

3 This is only the demand side of a growing international law market. Thousands of agencies, law firms, and arbitrage courts in Western rule-of-law states and offshore destinations compete intensely for lucrative clients from Russia, China and other places where businesses look for better institutions. Information leaks such as the recent "Panama Papers" have shown that the customers are not always bona fide businesses and exposed the crucial role that Western safe havens play in corrupt schemes of predatory officials, despite the regular scolding of these practices by Western politicians (Harding 2016). However, this article is not dedicated to the ethical concerns of this practice, but instead focuses on the questions that it poses for research on institutional development.

improvements. However, the paper argues that competitive contract law is based on two pillars – a flexible contract law and reliable commercial courts. It contextualises the aforementioned reform with another development that clarifies the limits of regulatory competition: At the same time when the Civil Code reform was implemented, the Supreme Arbitrazh Court (SAC) was dismantled in a surprising and swift change of the constitution, jeopardising the future of contracting under Russian commercial law.

The second motivation driving this paper is a theoretical one: The phenomenon of legal outsourcing demonstrates that the reach of economic institutions is not tied to national borders. Yet, the national scale is treated as an axiom by most frameworks on institutional development. In theoretical concepts such as the "stationary bandit," (Olson 1993) the "limited access order" (North, Wallis, and Weingast 2009) or "extractive institutions," (Acemoglu and Robinson 2012) international interaction is only an afterthought. Building on regulatory competition theory, this paper sets out to explore the consequences of the "overlapping" of contracting institutions between Western rule-of-law states and countries with weak institutions.

The article is structured as follows: Section 2 provides a short introduction to the literature on regulatory competition. Since this paper is mainly concerned with contract law, this area is discussed in more detail. Section 3 characterises Russian legal outsourcing and provides statistics to approximate its extent. The two case studies, the recent reform of contract law and the abolishment of the SAC, are presented in section 4. The applicability of regulatory competition theory is discussed for both cases. The conclusion (section 5) examines the possibilities of generalising from the Russian case and suggests questions for future research.

2. Literature on Regulatory Competition

The literature on regulatory competition evolved around the idea that governments of different jurisdictions compete with one another for residents and capital. In Hirschman's terms, it is concerned with the consequences of "exit" decisions by citizens and firms.[4] A paper authored by Charles Tiebout in 1956, in which he argued that competition for residents between US municipalities could lead to a more efficient provision of public goods, is the cornerstone of this school of thought. Much of the interest in regulatory competition can be explained with an inherent promise: Inter-jurisdictional competition could po-

[4] The exit/voice framework of Hirschman is often applied without analysing the consequences of "exit." However, for Hirschman "voice" was just an "alternative mechanism" that "can come into play either when the competitive mechanism is unavailable or as a complement to it" (1970, 3).

tentially be a mechanism that disciplines governments where they are not constrained by a constitution (Brennan and Buchanan 1980, 197; Edwards and Keen 1996). The optimistic view on competition between jurisdictions is most pronounced where the scepticism about the benevolence of governments is the greatest. Its hope is that lower barriers for people and capital to move across borders summon an invisible hand that can put the "leviathan" in chains. This raises the question if regulatory competition could also discipline authoritarian governments (Montinola, Qian, and Weingast 1995; Cai and Treisman 2005).

Over the last decades, the costs of moving to a different jurisdiction – a key determinant for the intensity of competition – have dwindled. Travel costs have lowered significantly and information technology has made the management of organisations across continents a lot less expensive. This facilitated an unprecedented integration of international capital markets. It soon became clear that increased regulatory competition does not only incentivise improvement of laws and institutions, but carries the risk of market failure as well. A "race to the bottom" is likely if there are external effects but no super-jurisdictional rules in place to guide the market forces (Kerber 1999, 226). This is often expected in environmental regulation, where pollution-intense businesses can be attracted by offering weaker regulation (Wilson 1996; Woods 2006). There are similar concerns that regulatory competition erodes labour standards, causes upward redistribution of wealth and facilitates tax-avoidance schemes by multinational corporations (J. D. Wilson 1999).

Leaving While Staying

Not only the intensity, but also the quality of regulatory competition has changed. While Tiebout (1956) and Brennan and Buchanan (1980) were concerned with the movement of people and capital across borders, this paper shows how firms can benefit from foreign jurisdictions *without* relocating. The best-known example of this is paying taxes in another jurisdiction through transfer pricing, a practice many multinationals have excelled in. However, firms also selectively benefit from institutions of foreign jurisdictions. There is an international "law market" that is fragmented into many different niches (O'Hara and Ribstein 2009). Companies can take advantage of a whole menu of competing regulations for each aspect of their operations. One firm may, at the same time, choose to pay taxes and incorporate in one, issue bonds in another and use the contract laws of a third country (Eidenmüller 2013).

With this increasing unbundling of regulatory competition, research has become more specialised as well. The existing literature has focused mainly on US states and EU countries: In the market of corporate charters, Delaware is often cited as the most remarkable success story (Romano 1985). For captive insurance, the state of Vermont is another example of a winner in regulatory

competition (Morriss 2008, 57). In the EU, the competition for incorporation was initiated when the European Court of Justice overturned the "real seat doctrine" in three seminal judgments between 1999 and 2003, with the consequence that European companies do not have to incorporate in the country where they do their business (Vogenauer 2013, 35). This resulted in a boom of newly-founded English "Limited" companies among small businesses in other countries of the EU. The competition of the "Limited," in turn, motivated the German government to reform corporate law and introduce a new type of incorporation called the *Unternehmergesellschaft* with similar conditions to those of the Ltd. in 2008 (Ringe 2011).

Regulatory Competition and Contracting Institutions

The literature on regulatory competition has also covered contract law, which is the framework of rules that "governs the enforceability of agreements" (Cane, Conaghan, and Walker 2008, 219) and forms one pillar of the contracting institutions analysed in this paper. The need to use foreign contract laws commonly arises when two firms from different jurisdictions conclude a cross-border transaction. In international agreements, two clauses are usually included in the contract: a choice-of-law clause that determines the governing law and a choice-of-forum clause that clarifies the places and the rules of dispute resolution. The parties of the contract can choose from a wide variety of different contract laws to find the rule system which best accommodates their preferences (Vogenauer 2013, 15).

The possibility to choose from different contract laws does not by itself constitute a competitive law market. On the one hand, a market requires that businesses choose contract laws based on qualities of the law, such as its flexibility. On the other hand, lawmakers have to react to the choices of businesses with the goal of increasing their market share. Rühl (2013) reviews a number of surveys of firms on contract law choices and finds that they are indeed sensitive to the quality of the law. Regarding the supply side, she points out that several new EU member states have adjusted their laws beyond what the *acquis communautaire* would have required, indicating that these states took the reforms as an opportunity to make their contract laws more competitive (Rühl 2013, 67).

Challenging Rühl's affirmative stance, Vogenauer (2013) argues that regulatory competition in contract law is negligible. According to Vogenauer, firms rarely compare different contract laws in their daily business. Assessing the comparative quality of contract laws is a costly process and the choice of law is often dominated by other factors such as bias for the familiar jurisdiction, language and economies of scale (using one jurisdiction for all contracts). The choice of contract law may additionally be distorted by principal-agent prob-

lems in the relationship between lawyers and managers. With regard to the supply side, Vogenauer asserts that lawmakers lack sufficient incentives to increase market shares in contract law. Although some European justice ministries have issued brochures that advertise their contract laws as the most business-friendly, Vogenauer sees no evidence for actual changes in contract laws aimed at improving competitiveness (2013, 61).

This paper argues that there *is* regulatory competition in contract law, as will be laid out over the following two sections. However, the market for contract law differs from the market for tax or corporate law in several aspects. Most importantly, the choice of contract law is closely connected to the quality of courts or other forms of dispute settlement and the available mechanisms of enforcement. Choice-of-law clauses in contracts are predominantly aligned with the choice of forum: Swiss courts will be more adept at applying Swiss contract law. Thus, contract law and the available litigation or arbitration options are complementary goods. The impartiality and expertise of Swiss judges is one reason for the popularity of Swiss contract law in international transactions. To understand what drives firms to foreign jurisdictions, not only the contract law, but also options for dispute settlement have to be accounted for. Taken together, they are the two pillars that the competitiveness of contracting institutions rests on.

3. Contract Law and Forum Choice in Post-soviet Russia

In the existing research on regulatory competition in contract law, the law market is commonly seen as the market for *transnational* contracts, i.e., border-crossing transactions. A strong home bias is assumed when the governing law for a contract is chosen (Vogenauer 2013, 23). In purely domestic transactions, the question of the appropriate contract law is rarely asked – it mostly is the domestic law which the contractual partners are familiar with. The perspective on the contract law market as the market for transnational contracts is based on empirical research in Western countries such as the US and the EU, where dispute resolution is similarly reliable. In the case of Russia, however, there are "entire segments of domestic activity that were structured specifically in order to use foreign legal infrastructure rather than domestic infrastructure" (Nougayrède 2013, 1–2). In their choice of jurisdictions, Russian firms display a *negative* home bias. There is demand for foreign law for purely domestic transactions. When deals exceed a threshold of about USD 20 Mio,[5] especially in mergers and acquisitions, the contracts are almost exclusively governed by foreign, mostly English law. Even a transaction as minor as the sale of real

[5] Estimate of one commercial lawyer, Moscow 2016.

estate in Russia increasingly involves the creation of an offshore holding through which the transaction of the property is handled (Hodge 2012).

Two practical questions guide a firm's decision on which jurisdiction to choose for contracting: Where should a potential dispute be adjudicated and how should the enforcement work? The dispute resolution fora which hear the most international commercial cases are private arbitration tribunals. Arbitration proceedings can be initiated if a specific tribunal is named in the choice-of-forum clause of the contact. Enforcement of arbitral awards is based on the "New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards" of 1958, in which more than 150 countries have committed themselves to recognising arbitration judgments.[6] However, this does not result in automatic enforcement. To receive compensation from assets which are registered in a member country of the New York Convention, the successful claimant must go through a state court in that country. Thus, assets in Russia will only be touched if a Russian court decides that the claim from the arbitration tribunal is legal as per Russian law. While Russian law does not forbid the choice of foreign contract law for Russian businesses, any enforcement based on an arbitral award under foreign law is possible in Russia only if a "foreign element" is part of the contract. In practice, therefore, a Russian-owned holding in Cyprus or other offshore jurisdictions is often included in an agreement.[7] In most cases, however, enforcement against assets in Russia is not necessary. Russian businesses can circumvent Russian jurisdiction altogether if all parties of a contract hold assets through offshore firms. A title can then be enforced in the offshore country. Recognition of an arbitral award in the European Union is much simpler than in Russia and can be used to access assets of the defendant, e.g. in Cyprus (Cox, Nesterchuk, and Asoskov 2013).

Disputes over contracts that are based on foreign law can also be settled in foreign state courts if these courts assume jurisdiction over the case. Here, the enforcement of decisions against assets in Russia is even more difficult and alternative enforcement abroad accordingly more important. Verdicts of the London Commercial Court, an English state court, cannot be enforced directly in Russia, since Russia and the UK do not have an agreement to mutually recognise judicial decisions. Yet, Russian businesses frequently choose the London Commercial Court for a number of reasons: It assumes jurisdiction in many cases which have only a remote connection to the United Kingdom,[8] and

6 A map showing all states that have signed can be found at http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention_status_map.html.

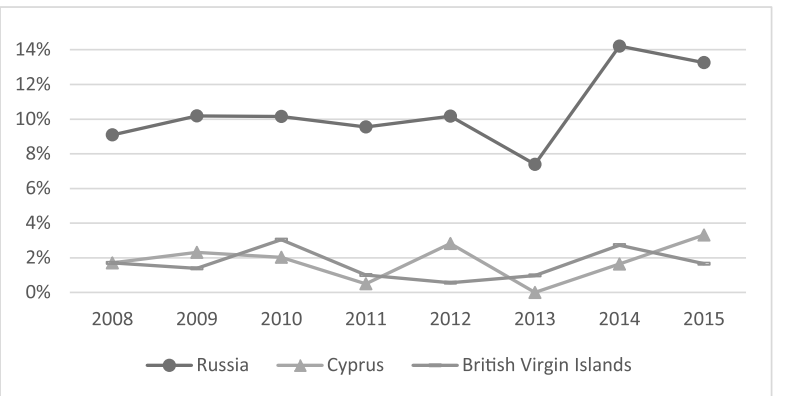
7 The question if a foreign element is always necessary is disputed (Ivory and Rogoza 201, 10–11).

8 In the case of Beresovski vs. Abramovich the connection was that the contract was agreed on in a London hotel room. Cases may also be accepted if they have no real

it has far-reaching possibilities for enforcement and injunctions, including a so-called "worldwide freezing order" for assets outside of the UK (Croft 2013, 2; Lein et al. 2015, 15).

Extent of Russian Legal Outsourcing

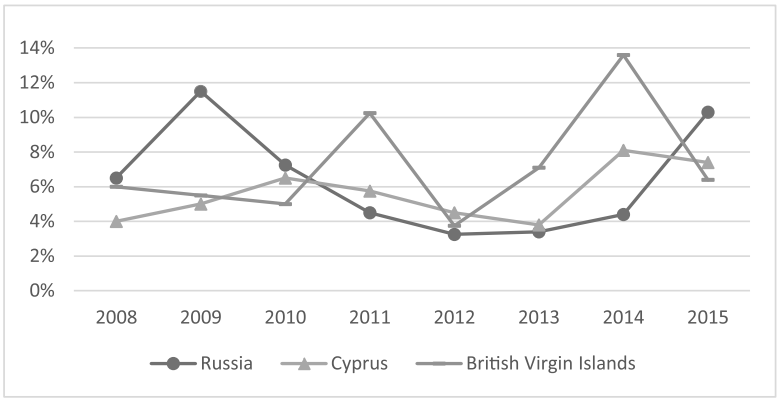
This section presents three approaches for estimating the extent to which Russian firms are using legal outsourcing. One way of empirically examining the use of foreign contract law and dispute resolution by Russian businesses is analysing caseload statistics. At the Arbitration Institute at the Stockholm Chamber of Commerce, Russian claimants and respondents are consistently the largest fraction among foreigners (SCC Arbitration Institute 2014). In the London Court of International Arbitration (LCIA), Russia ranks first to third among foreigners in most years (Lancaster 2015). These statistics still understate the presence of Russian claimants and defendants. Typical offshore destinations such as the British Virgin Islands (BVI) and Cyprus are frequent nationalities. As large parts of inward FDI to BVI and Cyprus is of Russian origin, a share of these disputes is eventually also connected to Russian beneficiaries. Finally, statistics on cases at the Commercial Court in London show that litigation in state courts also plays a role in resolving disputes of Russian firms, which have been second among foreign litigants (after US companies) for the past four years (Portland Communications 2015).



Source: Own elaboration based on caseload data from sccinstitute.com.

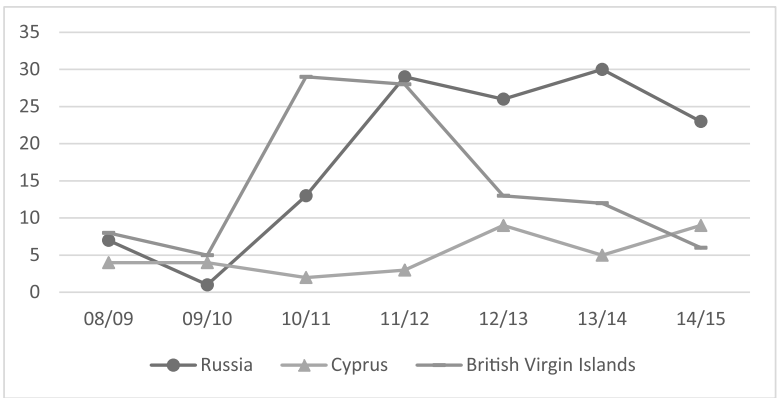
Share of Dispute Parties of Selected Nationalities at SCC (Stockholm)

perspective of being heard in any other court (see also Sharfutdinova and Dawisha 2016, supra note 99).



Source: Own elaboration based on data from LCIA registrar's reports, lcia.org.

Share of Dispute Parties of Selected Nationalities at LCIA (London)



Source: Own elaboration based on Portland Communications 2015.
The average total caseload in 2008–2015 was 145 per year.

Number of Dispute Parties of Selected Nationalities
at Commercial Court (London)

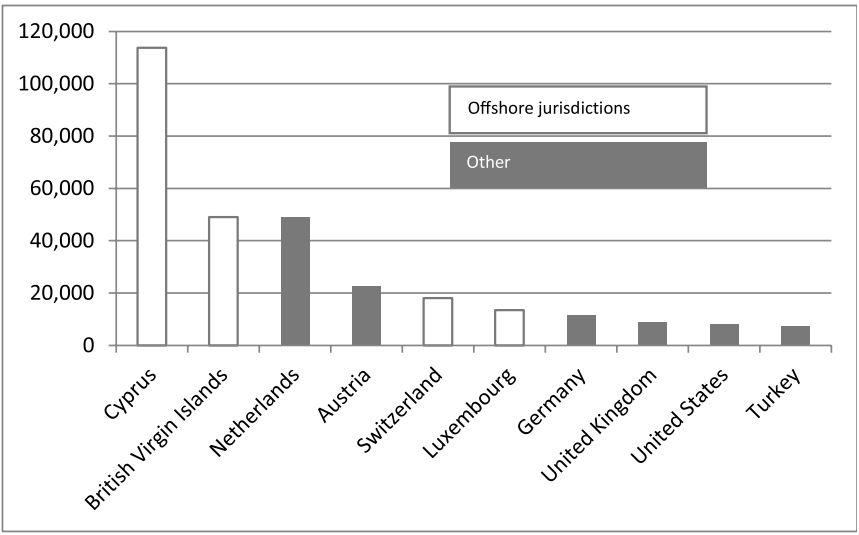
A second indicator for the extent of legal outsourcing is the "offshorisation" of the Russian economy (Wilson 2015, 132). It needs to be stressed that foreign contracting institutions are not the only reason for using offshores. Operating through a foreign holding can have several benefits, and it depends on the individual case which part of the "bundle" caused the decision to opt for a foreign jurisdiction. For some, the central motive is tax optimisation through manipulated transfer prices. Anonymity, the main selling point of the BVI, is the pri-

mary benefit for others. Even before the leak of the "Panama Papers" (Harding 2016), offshores have regularly been linked to laundering the proceeds of corrupt activities in Russia (Ledyaeva et al. 2015).

Legal outsourcing, characterised in this paper for Russia, is different from capital flight. For legal outsourcing, permanent relocation of capital is not necessary. Sometimes capital passes through offshore jurisdictions, but it returns to Russia through re-investment (Ledyaeva, Karhunen, and Whalley 2013). This "round-tripping" of capital appeared soon after Russia privatised most of its economy, as the early Russian businessmen quickly discovered the advantages of international business integration. For example, Mikhail Fridman, a typical Russian oligarch from the 1990s, structured his ownership in the Russian communications provider VimpelCom like a *matrioshka* puppet of shell companies in offshore havens: Fridman controls 'Crown Finance Foundation' (registered in Liechtenstein), which controls 'CTF Holdings' (Gibraltar), which controls 'Alfa Group' (Russia), which controls 'Altimo' (BVI), which controls 'VimpelCom' (Bermuda). The deep integration of the Russian economy with offshore centres[9], or *offshorisatsiya* as it is called in Russia, is evident in the country's FDI statistics. Several small jurisdictions make up the majority of both incoming and outgoing capital. As has been shown for Mikhail Fridman, capital often goes through several gateways before returning to Russia. The BVI are frequently chosen as the first link in the chain because they offer high secrecy and an "ask-no-questions, see-no-evil company incorporation regime" (Tax Justice Network 2015).

The third approach to estimate the extent of legal outsourcing are surveys of Russian firms. To collect more dependable data on the use of foreign law, a group of eleven large Russian law firms conducted a survey with 300 clients in 2012, asking them which share of their "important transactions" they structure using foreign law. The main result was that the majority of Russian businesses uses foreign law for at least 90% of these contracts. As for the reasons for legal outsourcing, two motives stood out, corresponding to the two pillars of competitive contracting institutions analysed in this paper: 67% of the respondents cited unpractical Russian commercial law, while 62% referred to the deficient Russian court system. The most curious result of the study was that only 14% pointed to foreign business partners as the reason for using foreign law in their transactions. This again confirms that Russian business uses foreign contract law mainly in transactions which are in fact domestic, even though they are mostly conducted through holdings in offshore jurisdictions (Afanas'ev 2012).

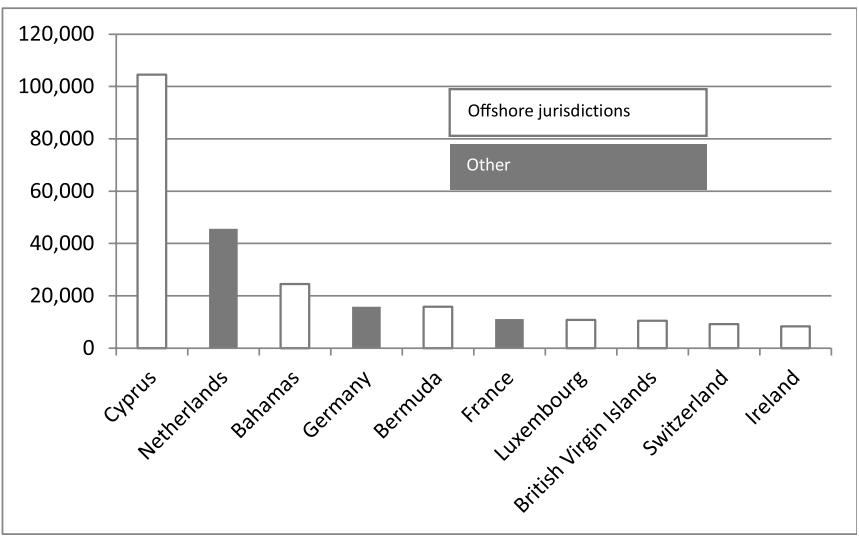
[9] There is no common definition of what constitutes an offshore jurisdiction. In figure 4 and figure 5, a list compiled by Palan et al. is used (Palan, Murphy, and Chavagneux 2010). In this paper, a country is considered an offshore jurisdiction if it is classified as a tax haven by at least 8 of 11 sources (*ibid.*, 2010, 41).



In Mio. Dollars (directional principle).

Source: Central Bank of Russia; <http://www.cbr.ru/Eng/statistics/?PrtId=svs>.

Stock of Outward Foreign Direct Investment from Russia, July 2015



In Mio. Dollars (directional principle).

Source: Central Bank of Russia; <http://www.cbr.ru/Eng/statistics/?PrtId=svs>.

Stock of Inward Foreign Direct Investment in Russia, July 2015.

Two Reasons for Legal Outsourcing

It is crucial to differentiate between the two main drivers of legal outsourcing uncovered by this survey. The first reason is that, until a recent reform of contract law, Russian law lacked many legal institutes which are necessary to structure complex transactions. These shortcomings concerned, above all, deals in mergers and acquisitions (M&A). As a consequence,[10] the highly lucrative market for law consulting in M&A in Russia is today dominated by Moscow subsidiaries of foreign law firms.[11] Here, English law is most widely applied (Ivory and Rogoza 2011), because it recognises a number of contractual provisions which help mitigate risks in complex transactions. A few notable examples are:

- **Representations, warranties and indemnities**: These clauses are commonly included in contracts to reassure the other party about certain facts that are meaningful in the transaction. For example, during the acquisition of a company, a warranty could be included in the contract stating that the company has no outstanding loans, giving the buyer the right to sue for damages if he discovers a loan after the transaction has been concluded.
- **Put and call options**: These contracts give one side the right to decide if a transaction should take place on previously agreed conditions at a later point in time.
- **Pre-contractual liability (***culpa in contrahendo***)**: Because the negotiation of agreements is connected to costs and the disclosure of information to the potential business partner, negotiations can be abused to damage the other side or to gain sensitive information about a competitor. English law recognises pre-contractual liability if a party enters into negotiations in bad faith (Gorodissky and Lubomudrov 2015).
- **Escrows**: Under English law, funds can be placed in a retention account or held in escrow by a third party (e.g. an escrow agent) until certain conditions specified in the agreement are fulfilled.

These concepts and legal institutes were summarily not recognised by Russian contract law until a recent reform of the Civil Code. In some cases, acceptable outcomes could be achieved with Russian law by bending other legal instruments as a work-around. However, unless foreign law was used, many uncertainties remained (Konnov, Yuriev, and Shalamova 2015).

The second reason for legal outsourcing is that Russian firms want to avoid Russian courts. This is due to several factors, such as a lack of professionalism

[10] The dominance of foreign law firms is not only a consequence of legal outsourcing, but also one of the reasons of it.

[11] In the prestigious Chambers law firm ranking, there are almost no Russian firms present in the M&A category (Chambers and Partners 2016). The Mergermarket ranking of consulting volume lists the first Russian law firm on position 13 for M&A deals in Russia (Bazanova 2015).

and experience. The key issues, however, are corruption and politicisation of the courts (Ledeneva 2008; Hendley 2009). For example, Russian commercial courts played an important role during the expropriation of Mikhail Khodorkowski. Russian businessmen try to reduce political risks by conducting deals out of the reach and sight of Russian officials (Nougayrède 2013, 30). Arguably, only a small fraction of cases is unequivocally decided on a political basis. Kathryn Hendley points out that there is a legal dualism of "regular justice" and "telephone justice" in Russia (2011). However, the mere possibility of a transaction becoming political at some point increases the risks beyond the actual number of visible political interventions. Despite this overall gloomy picture, there have been improvements in the commercial court system in recent years, thanks to the reform efforts of the SAC which is laid out in more detail below.

Besides these two main causes of legal outsourcing, there are also underlying historical factors. The triumph of foreign law in Russia has been facilitated by the openness of its market for law services. In the 1990s, Russia lacked experienced business lawyers, and English and US law firms were able to move in to meet the demand (Nougayrède 2013, 3). For these firms, it was beneficial to offer the law they were familiar with and the principal-agent problem inherent in the lawyer-client relationship boosted the role of foreign law.

4. Reforming Contracting Institutions

This paper presents two case studies on recent reforms of the Russian Civil Code and the Supreme Arbitrazh Court. The research design resembles the comparative analysis of a "most-similar" set of cases (Gerring 2006, 131). In an ideal setting of regulatory competition, both reforms should have positive outcomes, i.e., more competitive contracting institutions as a reaction to legal outsourcing (Tiebout 1956). Besides the incentives for improvement, both reforms were passed by the Duma in a similar political setting within less than two years. This section aims to generate hypotheses that explain the contrary outcomes of the reforms. To uncover the causal relationships behind the reform outcomes, process tracing has to be used (George and Bennett 2005, 205; Gerring 2006, 172). In preparation for this study, interviews with two legal scholars and five lawyers who are practicing international private law in Russia were conducted in April 2016. The Russian media archive Integrum was used to triangulate the information gathered and to create a chronology of events.

Case 1: Reform of the Russian Contract Law

The latest reform of the Russian contract law can be traced back to an initiative of the "Council for Codification" (CoC), a group of law scholars that had also developed the original Russian Civil Code in the mid-1990s and believed that it needed to be updated. Following the CoC's initiative, president Medvedev signed a decree in July 2008 that mandated the council to develop a reform concept for the Civil Code until 1st of June 2009 (Kremlin.ru 2008). When the results were presented in October 2010, they ignited a flurry of lobbying by different groups and ministries which tried to join and influence the reform effort (Vasil'ev 2011). While the CoC's concept[12] focused on coherence with the tradition of civil law and stricter rules for business, three opposing actors lobbied intensively to make the Russian law more practical for businesses by adding instruments known from English common law and increased support for the freedom of contract (Stepanov 2011).

The first major proponent of market-oriented changes was the Ministry of Economic Development (*MinEkonomRazvitiya*) which was headed by El'vira Nabiullina at the time. The main concern of the *MinEkonomRazvitiya* was that the CoC's original proposal would scare off investors (Vasil'ev 2011). The second major actor in the reform process was the taskforce for the creation of an international financial centre in Moscow (MIFC Taskforce 2017). The MIFC Taskforce was a project initiated by former president Medvedev and led by Aleksandr Voloshin, head of the presidential administration during Putin's first term in 1999–2003. Together with *MinEkonomRazvitiya*, the MIFC Taskforce wrote a second, rival proposal for the reform of the Russian Civil Code which focused on making the new laws as business-friendly as possible (Dmitrii Kaz'min and Glikin 2011).

The third major interest group in the reform process was a business association. In 2011, the eleven largest Russian law firms created the "Partnership for the development of corporate law." ("Sodeistvie razvitiyu korporativnogo zakonodatel'stva" – NP "SRKZ" 2016) As one of the founding members explained in an interview, the initiative was motivated by worries about the future demand for the services of Russian law firms:

> "We realised in 2010 that we were losing our market. Actually, we had lost it ten years ago, but we realised that we wanted to change the status quo and decided that the first step would be to bring the Russian commercial laws to Anglo-American standards. There is still another part of this problem, the Russian judiciary or Russian courts, but we had to start somewhere. So we decided to start with the easiest part: legislation." (interview with partner of Russian law firm, 2016)

[12] The original proposal of the CoC can be found under http://privlaw.ru/sovet-po-kodifikacii/conceptions/.

The primary goal of the partnership was to "improve competitiveness and effective application of Russian corporate law" (NP "SRKZ" 2011a). After the partnership was formed, it set up 17 working groups which prepared their own version of the reform law with extensive commentary (NP "SRKZ" 2011b). The results were sent to key figures in the reform process and presented in a press conference as well as at an international law congress (NP "SRKZ" 2012a). The partnership also conducted the abovementioned survey of 300 of its clients and published it in May 2012 in Vedomosti, a major business newspaper, under the headline "10% sovereignty," as only 10% of the companies in their sample preferred Russian law for the majority of their significant contracts (Afanas'ev 2012).

To resolve the conflict between the CoC and the market-oriented lobby, in late 2011, Medvedev mandated the Ministry of Justice to arbitrate and to create a unified proposal. In the following months, a working group that consisted of representatives from the CoC, the MIFC Taskforce, the MinEkonomRazvitiya and the corporate lawyer's partnership, met for several hours each week and struggled to find a compromise. The negotiations continued until April 2012, when Medvedev eventually introduced a reform law compromise to the State Duma. This compromise was much more business-oriented than the CoC's original proposal. In these improvements (from the perspective of the market-friendly lobby) the most important previously lacking legal institutes of English law were included (all articles refer to the new Russian Civil Code). In the case of escrows, the Russian law even adopted the foreign term "escrow," making no secret of its English role model (Lokteva 2015).[13]

- **Representations, warranties and indemnities:** Article 431.2 and 406.1.
- **Put and call options:** Article 429.2 and 429.3.
- **Pre-contractual liability:** Article 434.1.
- **Escrows:** Article 860.7 (*Dogovor scheta eskrou*).

Overall, the reform increased the flexibility of Russian contract law and made it easier for businesses to safeguard their transactions (Konnov, Yuriev, and Shalamova 2015; Zanina and Raiskii 2015). All three market-oriented groups self-identified with the motive to make the Russian contract law more competitive. In official statements and interviews on the reform motives, the

[13] Yet, the new Civil Code is not a legal transplant. In several instances during the 1990s, a set of rules from a foreign legal context was implemented in Russia, often with counterproductive outcomes (Berkowitz, Pistor, and Richard 2003a; 2003b; Lambert-Mogiliansky, Sonin, and Zhuravskaya 2007). Usually, the motive behind legal transplants is to save precisely the kind of time and effort that the overhaul of the Russian Civil Code took. In contrast, although the reform of the Civil Code was far reaching, it was still incremental change compared to the demands of Russian businesses and their experiences abroad.

improvement of competitiveness was a common narrative among all groups.[14] The lawyers' partnership had a clear financial incentive to keep Russian businesses from choosing a foreign jurisdiction. They were driven by a dwindling market for Russian consulting on Russian law contracts. While regulatory competition research often models the "regulator" as a unitary actor, in any reform process there are several competing interests involved on both sides with different motives (Bernauer and Caduff 2004; Radaelli 2004) and ideologies (Heinemann and Janeba 2011). Lawyer associations play a central role because they are the most "exit-affected interest group," face low internal hurdles for collective action and possess the necessary legal know-how needed for successful lobbying (O'Hara and Ribstein 2009, 74).

The impact of the lawyers was visible in the public debate on the Civil Code reform, both through interviews (e.g. Nikolayev 2011; Stepanov 2011) and guest contributions in mass media (Afanas'ev 2012). The results of the partnership's survey were widely reported and, later that year, echoed by Putin in his address to the Federal Assembly:

> "Our entrepreneurs are often criticised for lacking patriotism. The high degree of offshore investments and ownerships in the Russian economy is an absolute fact. Experts call this phenomenon fleeing from jurisdiction. According to some assessments, nine out of ten major transactions made by major Russian companies are not regulated by Russian laws – including, incidentally, companies with state participation" (Kremlin.ru 2012).[15]

When comparing different law drafts with published suggestions by the partnership, the law firms' input can also be traced in fragments that appeared first in their suggestions and were later included in the law. The impact is further corroborated by a letter that the partnership sent to the *MinEkonomRazvitiya*, in which the lawyers point out their satisfaction over the process, stating that "the voice of business was heard" and many suggestions made by the partnership were considered (NP "SRKZ" 2012b).

Case 2: Abolishment of the Supreme Arbitrazh Court

This apparent improvement of the Russian contract law stands in striking contrast to the events that unfolded in the Russian court system at the same time. While the law was made more competitive, attempts to make commercial courts more transparent and reliable were reversed by the Kremlin.

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[14] The MFC working group calls its motives the "desire of professional market players to improve the business climate, make the Russian financial market a viable part of the global market, and boost its attractiveness for foreign investors and issuers" (MIFC Taskforce 2016).

[15] Because there is no other statistical assessment available and because Putin refers to numbers from the lawyers' study, it can be asserted that he is referring to it.

In the Russian judiciary, commercial cases between legal entities (including the government) are heard in a separate tier of courts called *arbitrazh*.[16] The SAC, the final instance of these commercial courts, was led by a relatively young former lawyer, Anton Ivanov. Soon after becoming the chairman of the SAC in 2005, Ivanov began implementing reforms to increase reliability and – above all – transparency of judicial proceedings. He obliged all commercial courts to make their decisions public. Before this, judgments had only been accessible to the dispute parties (Vedomosti 2005). In 2012, he initiated a reform project which aimed to completely open up judicial hearings to the public, including the media (Dmitriy Kaz'min and Kornya 2012). The SAC threatened to annul any sentence of lower court instances if public access was not granted during the proceedings. If necessary, the commercial courts were responsible for finding a courtroom big enough to accommodate every interested citizen. Visitors were granted the right to make audio recordings without prior notice in courtrooms and publish these recordings anywhere, including radio and social media (Feklyunin 2012).

The SAC was also more vocal than other courts in defending itself against attempts to influence decisions by state organs. In late 2006, Ivanov criticized the Federal Tax Service for exercising political pressure in a case against the international joint-venture TNK-BP (Pleshanova and Solov'yev 2008). In May 2008, the SAC became the first Russian court to acknowledge political pressure from the Presidential Administration. In a defamation case of Kremlin official Valeriy Boyev against a journalist who had pointed out corruption in the Russian court system, Ivanov's first deputy Elena Valyavina testified that she had in fact been threatened by the same official before (Kommersant 2008).[17]

Ivanov's efforts to improve dispute resolution in Russia came to an abrupt end in 2013, at a time when the reform of the Civil Code (case 1) was in full swing. On 21st of June 2013, president Putin revealed a plan to change the constitution and abolish Ivanov's SAC. The Supreme Court of the general court system was to take over the SAC's tasks and personnel. Additionally, it was then to relocate from Moscow to St. Petersburg, geographically leaving the centre of political power. The constitutional court had already been moved to St. Petersburg in 2008, which had severely disrupted its work (Henderson 2015).

The merger with the Supreme Court and the relocation to St. Petersburg dissolved the nucleus of judicial improvement that the SAC had become. Ivanov was to be demoted and become a subordinate of 70-year-old Vyacheslav Lebedev, a veteran judge from the Soviet Union who had been the chairmen of

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16 *Arbitrazh* courts are state (litigation) courts, not arbitration tribunals as the name might suggest.

17 Valyavina had accepted a case for review in which the Ministry of Property Relations attempted to reverse the privatisation of stocks from the company TogliattiAzot when Boyev threatened to block her re-appointment (Ledeneva 2013, 163).

the Russian Supreme Court since 1989. In contrast to Ivanov, Lebedev had not achieved notable improvements or reforms in the general court system (Partlett 2014). The new body of judges that was to administer the economic disputes under Lebedev was also downsized, and the terms of all SAC judges were formally ended. They were to undergo a new selection process.

Already in the first days after Putin submitted the proposal to amend the constitution to the State Duma, veteran judges of the SAC began handing in their resignations (Moscow Times 2013). The professional community, which was able to make its voice heard during the reform of the Civil Code had no effect in this case: "The strong objections, warnings, and suggestions from judges, legal scholars, and the business bar were all but ignored, by both deputies in the State Duma and the drafting group in the State Legal Administration of the President." (Solomon 2014, 2) The change was carried out swiftly and without any discussion. Within six weeks, the Duma passed the new legislation. It was signed by Putin in February 2014 (Kremlin.ru 2014). In August 2014, the SAC was shut down (Zakon.ru 2014).

In the official explanation of the reform, it was presented as an attempt to strengthen the integrity of the Russian court system (Mishina 2013). There are several other interpretations on the actual motives behind the highly disruptive intervention. Some observers connect it to personal animosities against Ivanov, his lavish lifestyle and the privileged courts that he set up for the business clientele (Solomon 2014, 4). Because Ivanov was a classmate of Prime Minister Dmitri Medvedev at the university in St. Petersburg, there was also speculation that the move was meant to reduce Medvedev's influence (Rostovskiy 2013). Other analysts noted that it was the politically motivated "destruction of the last remnants of judicial autonomy" (Petrov 2015). The transparency introduced by Ivanov had made it harder to politically influence cases in the commercial courts (Partlett 2014).

In case study 1, regulatory competition created financial incentives for the law firms to work towards a business-friendly reform of the Civil Code. The motives of Anton Ivanov and his colleagues seem to be of a more intrinsic nature. Several interviews show that Ivanov was aware of legal outsourcing and very unhappy about it. However, while acknowledging the shortcomings of the Civil Code, he rather blamed the Russian tax regime, rhetorically asking "Do you think that if the legal institute of 'warranties' appears in Russia, Russian entrepreneurs will stop to incorporate in offshores" (Kashirin 2011)? Ivanov also drew a lot of attention at an international law conference in May 2012 when he proposed drastic countermeasures to defend against "unfair competition from foreign jurisdictions," which he considers an encroachment upon Russian sovereignty (Zanina 2012).

Overall, while the legal norms of Russian contracting institutions were improved, the judicial pillar experienced a serious setback. It will take some years

until the effects of both interventions become visible. In the interviews conducted for this study, lawyers reported an increased interest among their clients for structuring transactions within the Russian jurisdiction after the reform. Yet, there are also unrelated causes for the increasing demand for Russian law: The ongoing economic crisis in Russia, Western sanctions and the rouble exchange rate also contributed to this development. Businesses have become more cost-sensitive and the prospect of expensive litigation or arbitration abroad is making Russian contract law more attractive (Bazanova 2015).

5. Conclusions and Implications

Global economic integration has enabled businesses in countries that lack reliable contracting institutions to find substitutes abroad. This paper examined whether regulatory competition can contribute to reversing this trend. The business-friendly changes in the Russian Civil Code can be traced back to market-oriented lobbying, which in turn was largely a reaction to the extensive legal outsourcing and the "offshorisation" of the Russian economy. However, the "invisible hand" of regulatory competition did not reach the Russian court system. This is demonstrated by the unexpected and disruptive abolishment of the SAC, which was trying to introduce more transparency and independence in the Russian judiciary. Taken together, both cases offer a glimpse into the sometimes contradictory politics that shape economic institutions under authoritarianism.

The two cases clarify once more why most authoritarian governments struggle to improve the business climate: To control internal affairs, the Kremlin regularly interferes with the judiciary, as former deputy chair of the SAC, Elena Valyavina, testified. Attempts to increase transparency and reliability such as Ivanov's reform efforts will eventually collide with the leadership's interests. Curiously, the partial loss of control which is caused by legal outsourcing might well make it *more* important for the Kremlin to keep the Russian commercial courts under control, because they decide if claims won in a foreign court can be enforced in Russia. Thus, what sets the case studies apart and explains their apparently contradicting outcome is, at the bottom, their potential to affect elite control over the distribution of wealth. The Civil Code reform and the abolishment of the SAC resemble a policy equivalent of the legal dualism that Kathryn Hendley (2011) identified for Russian court cases: Regular reforms and politicised reforms take place under the same administration, however in completely different fashion and with different outcomes. Regulatory competition only affects non-politicised reforms. While it facilitates the improvement of non-sensitive aspects of the legal environment, it cannot tame the "leviathan."

Some of the disparities of the two cases also point to differences between Medvedev's and Putin's presidencies. Important interest groups such as the

MIFC Taskforce were created by Medvedev, whose policies were less restrictive and focused more on catching up with Western standards. Under Putin, a different approach to reigning in legal outsourcing was implemented: A new de-offshorisation law was passed by the Duma to restrict businesses' legal mobility (Zakon.ru 2013). Going forward, it is likely that there will be more deterring policies to contain legal outsourcing. However, there is a trade-off for the Kremlin: While more restrictive policies increase control over domestic business affairs, it contradicts the personal interests of Russian elites who are heavily invested abroad themselves. Thus, foreign courts and arbitrage tribunals will remain a vital part of the Russian economy. If the lawyers' indications are valid, Russian law will be used more widely. In response, it can be expected that foreign arbitral tribunals will try to diversify to also hearing cases governed by Russian law.[18]

Overall, the phenomenon of legal outsourcing is not uniquely Russian. The caseload data shows that contracts involving Ukrainian, Kazakh or Nigerian businesses frequently end up in foreign courts and arbitration tribunals as well. Often, the dispute parties face off against their countrymen in Europe (Portland Communications 2016). When generalising the findings of the case studies, the characteristics of the Russian economy and political system must be considered. The size of the Russian economy improves the chances for regulatory competition because it leads to the creation of a specialised and qualified lawyer community trying to improve contracting institutions, and the concentration of their business in Moscow makes collective action more likely.

Regulatory competition can also incentivise the creation of separate enclaves for foreign businesses to offer them reliable courts while keeping political control over the home economy. One example for this is the Dubai International Financial Centre (DIFC), which is the template that the Russian MIFC Taskforce was aspiring to follow. The DIFC not only operates under a parallel legal system based on common law, but also features its own judiciary which is separate from the national courts of the United Arab Emirates (Carballo 2007).

The developments presented in this paper provoke further questions and require a rethinking of long-term institutional development. Further research should focus on collecting more empirical data from other countries to complete the picture. Another promising starting point is the hypothetical reconsideration of common development narratives under today's circumstances: How would, for example, England's institutions have developed if the Stuarts had used legal outsourcing when borrowing money before the Glorious Revolution (North and Weingast 1989)? The increasing international economic integration entails the erosion of national borders between jurisdictions. The lack of trust

[18] Until the improvement of the Russian Civil Code, there was no reason to choose Russian law and a non-Russian forum in the past. However, there is precedence for the application of Russian law in English courts (Mitchell 2013; Goldberg et al. 2015).

in commercial courts in most authoritarian countries will continue to facilitate a deeper interlocking with Western jurisdictions and strengthen the role of enforcement abroad.

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