

Jānis Rozenfelds

*Dr., Associate Professor, University of Latvia*

# Latvian Property and Collateral Law and Protection of Foreign Investments

## 1. Sources of law and absolute rights of the proprietor

Main sources are the Constitution of the Republic of Latvia, the Latvian Civil Law Act, and the Commercial Pledge Act. The Latvian Civil Law Act as a code of institutional system, which is similar to the French code, was restored in Latvia in its structure of 1937.

Part III of the Latvian Civil Law Act, which specifically deals with property and collateral rights, was introduced by the Act on the Time and Procedure by which the Part of Introduction, Inheritance Rights and Rights on Things of the Renewed Republic of Latvia 1937 Civil Law Act Takes Effect as of 7 July 1992.

Initially, the Constitution of Latvia did not deal with any property rights at all. Amendments of such kind were passed only in 1998, when the additional chapter 8 on fundamental human rights was introduced, which included section 105 stating that everyone has the right to property. This important amendment introduced a new understanding of property rights compared to a more conservative view reflected in the Latvian Civil Law Act.

The Latvian Civil Law Act states in section 927 that property means having total power over a thing, *i.e.* the right to possess and use it, receive all possible benefit from it, handle it and demand the return of it from any third person by claiming ownership. In addition to this general principle, section 928 declares that although property may be restricted according to private will or by the law, any of such restrictions shall be interpreted in its narrow meaning, and in case of doubt it shall always be assumed that the property is without restriction.

According to section 1038 an owner may be in possession of a thing, which belongs to him or her, receive its fruits, use it at will to increase his or her assets, and in general, use it in any way, even though it may cause a loss to another person.

Contrary to these provisions, section 105 of the Constitution states that property may not be used against the interests of society.

## 2. Classification of things as objects of property rights

The Latvian Civil Law Act uses common classification of things as tangible and intangible (section 841). However, in dealing with a difficult question, what could be a subject of property rights, the Latvian Civil Law Act is nearly as narrow as the early Roman law. This approach is causing difficulties each time when one is confronted with the problem of rights regarding intangible things.

Although the Latvian Civil Law Act declares that a subject of property may be anything that has not been taken out of circulation by law (section 929), this general declaration is not supported by any other norm. Even further, in dealing with particular elements of the property rights, the authors of the Latvian Civil Law Act carefully avoided using the term “property” in relation to intangibles. Thus, regarding the claim of ownership, section 1050 expressly states that the subject of a claim of ownership may be a separate item as well as an aggregate of things consisting only of tangible things, but not a thing, which is composed of both — tangible and intangible things.

There is no doubt that in light of such clearly stated limits, a claim for intangible things is out of the question — it is hardly surprising that the same narrow approach also prevails in practice. The Latvian Constitutional Court found in favour of this more narrow approach. It was a particular case of interpreting section 105 in the meaning that a person’s right to property does not include his or her right to certain claims.\*<sup>1</sup>

### 2.1. Movable and immovable things, and buildings in particular

As provided for by section 842, tangible things are either movable or immovable, “depending on whether or not they can be moved without exterior damage from one place to another”. This general principle apparently includes not only land, but, by extension, buildings as well as other permanent structures. In the Latvian legal environment this fullest sense of the word “immovable” was not only extensively used with regard to buildings, but somehow led to a phenomenon, which could be defined as separation of buildings from the land in a way which is not clearly defined by the Latvian law and is regarded in the Latvian practice as an exclusion from the common principles the Civil Law Act is based on.

It must be pointed out that the 7 July 1992 Act on the Time and Procedure by Which the Part of Introduction, Inheritance Rights and Rights on Things of the Renewed Republic of Latvia 1937 Civil Law Act Takes Effect has established a very important principle as compared with the original meaning of the Latvian Civil Law Act.

As section 968 of the Latvian Civil Law Act states, a building, constructed on and firmly attached to a piece of land, shall be considered a part of same. According to section 973 trees and other plants, which have been replanted on another person’s land, belong to its owner from the time they have become rooted in this land.

Section 14 of the 7 July 1992 Act stated otherwise — that the provisions of sections 968 and 973 of the Civil Law Act shall not be applicable in cases when a building has been built (legally acquired in another way) or the orchard (trees) has been planted on the land allocated for this purpose in accordance with the laws in effect at that time, but the ownership rights to the land have been renewed to the previous owner or his or her heirs (assignee). It soon becomes clear that this important amendment, which was initially designed as just a temporarily introduced exclusion from general principles, is here to stay permanently.

Once Pandora’s box was open, this notorious section 14 started to accumulate more and more so-called exclusions from the general principle. Soon it was discovered that the rule on buildings as separate items was also applicable to the unfinished ones, and sometimes even to the tiny remains, which laid covered deeply in the ground and, like an accident waiting to happen, were threatening the previous owners whose rights were restored by a special law. These remains and their consequences were as unpredictable and at the same time as inevitable as natural forces. It sometimes seems that the more desperately legislators are trying to extinguish these so-called exclusions, the

<sup>1</sup> 20 April 1999 Judgement of the Republic of Latvia Constitutional Court. C. Case No. 04-01 (99). Available at: [http://www.satv.tiesa.gov.lv/Eng/Spriedumi/04-01\(99\).htm](http://www.satv.tiesa.gov.lv/Eng/Spriedumi/04-01(99).htm).

more difficult is the life they deliver both to the owners of the land and to the owners of the buildings separated from each other and deeply divided by this controversy.

During the denationalisation and privatisation period this controversy provided countless litigation cases and hundreds — if not thousands — of them are still waiting to be resolved.

Separation of the buildings from the land is a clear example of difficulties, which arise when an old act is taken as an orchard and planted in an adverse environment, which is fertilised by a different way of thinking. When the Act on the Time and Procedure by which the Part of Introduction Inheritance Rights and Rights on Things of the Renewed Republic of Latvia 1937 Civil Law Act Takes Effect was drafted, the authors of this bill had to take into account the fact that the land reform and denationalisation was still continuing. Therefore the reintroduction of the Civil Law Act of 1937 had a purpose to facilitate this process and not to become an obstacle in its way. The authors of this bill had also to consider that separation of the building from the land was at the time a matter of fact, which could not be averted.

As it is well known, in 1940, nationalisation was also carried out in several separate steps. Land was seized first, buildings and enterprises were seized afterwards. Denationalisation was reflecting the same order of steps, but taken the other way around.<sup>2</sup> First, the rural land reform Decree on Land Reform in the Republic of Latvia rural regions was passed in 1990. The city land reform Decree on Land Reform in the Republic of Latvia Cities was passed in 1991. The rural land privatisation Decree on Land Privatisation in Rural Regions was passed in 1992 (the rural land reform completion Decree on Completion of Land Reform in Rural Regions was passed in 1997, but the city land reform completion Decree on the Completion of Land Reform in Cities — in 1999). Decrees on privatisation of buildings always followed land reform decrees. For instance, the agriculture and fisheries privatisation Decree on Privatisation of Agricultural Enterprises and Collective Fisheries was passed in the same year of 1991.

It has to be underlined as well that the whole privatisation process — in which Latvia is notoriously behind most of the other East European countries — was in a permanent process of legislative changes, which continued from the early nineties up to 1994, when the public property privatisation Decree on the Privatisation of Objects of State and Municipal Property as well as a package of necessary supplementary laws were finally passed, under which, at long last, the privatisation of countless enterprises could take place.

The Denationalisation of Buildings in the Republic of Latvia Act was passed in 1991 and is in force from 1 January 1992. Thus, when the Civil Law Act was introduced, separation of the buildings from the land was already there. The great failure of dealing with this problem in 1992 was the fact that the legislation facing this problem did not provide a theoretical solution, but chose a shaky mode of exclusions instead. The result was that by trying to avert, not solve the problem, and by intending to sweep it under the carpet, the legislator in fact deepened the problem and, as time passed by, made it into one more and more difficult to solve.

One can only guess which way this contradiction between the law of 1937 and its contemporary legal environment could be resolved.

In general there are two extremes in proposed ways for solving this problem. One extreme is to extinguish this separation altogether and return to classical principles of the Civil Law Act of 1937. Another extreme is to re-establish *emphiteuzis* — a situation when a person who is not the owner of a piece of land is entitled to use it as his or her own in perpetuity, as he or she is an owner of the building, which was already there before the Civil Law Act of 1937 was originally introduced. Today, the difficult relationship between the owner of the building and the owner of the land under this building is solved through the so-called mandatory rental agreement between them.

To my own understanding, *emphiteuzis* is the only way to solve this problem, and it is already present in our real legal environment except for one feature; in today's situation, a person who is not the owner of a piece of land, but who is entitled to use it as his or her own in perpetuity as a building owner, is not subject to forfeiture for non-payment of a fixed rent.

This is nearly the only feature, which distinguishes the Latvian situation from the Roman or, if you like, the Feudal ownership of the Middle Ages. We can learn from history, which gives us a lesson in the form of a similar situation, which the Latvian state had already faced when the Civil Law Act was introduced in 1937. A specific procedure of buying out landlords' rights for the land was

<sup>2</sup> J. Rozenfelds. Problems of legislation on privatization in Latvia. *Wirtschafts- und Gesellschaftsrecht Osteuropas im Zeichen des Übergangs zur Marktwirtschaft*. Redaktion W. Seiffert. München: C. H. Beck'sche, 1992, pp. 355–358; Latvia: Legislation and denationalization of land. — *The Law Institute Journal*, 1993, May, pp. 258–259.

established. The owners of the buildings were reluctant to follow this procedure, and when the Latvian legal system was extinguished altogether in 1940 and 1941, the former relationship was still there.

## 2.2. Vessels

Another problem of the classification of things, which has led to far-reaching consequences in practice, could be found in a very short appendix to section 842. This appendix says that the railway with all its accessories shall be considered an immovable thing, but ships with all their accessories — movable things. This principle makes the implementation of the maritime lien or seizure of the vessel, as it is provided for by section 60 of the Latvian Maritime Code Act of 1994, highly unlikely due to procedural difficulties connected with the above principle which states that ships must be considered as movable things.

In practice it leads to fairly serious consequences, especially in the area of protecting rights of foreign companies and individuals who happen to deal with Latvia in the maritime area.

Let us suppose that a foreign company has a claim towards another foreign company, none of them is registered in Latvia, but the defendant is a ship owner, and the ship happens to be in the Latvian harbour.

Under the Latvian maritime law and the Latvian civil process law, the claimant is entitled to impose the lien on this ship unless the defendant pays his debt.

However the problem is that the same Latvian Civil Procedure Code does not entitle one for a claim, which could be submitted to a Latvian court towards a foreign company or an individual unless he or she has some kind of a legal entity representative or some immovable property inside the Latvian territory.

The watershed lies between the personal property and the immovable one. You cannot sue a foreigner in Latvia on the basis that he or she has some kind of assets here unless you prove that he or she owns land or other immovable property in Latvia.

It would be easy to handle such cases if only the Latvian Civil code regarded a ship as immovable. Unfortunately this is not the case. For this reason such cases, while initiated in Latvian Courts, usually fail, and such ships, after the claims to seize them are heard and rejected by Latvian Courts, quickly disappear from Latvian harbours.

I see no other possible solution of this problem but to change the principle stated in section 842 of the Latvian Civil Law Act and to declare that ships shall be considered as immovable things.

## 3. Pledge

The Civil Law Act states that a pledge right is a right to another person's thing (section 1278). It is a kind of purely Roman view on the pledge, contrary to the more contemporary view on this institute as a tool increasing commitment rights.

Pledge in the Civil Law Act is regulated in part III as one of the chapters devoted to property in general, or — as it is defined in the Latvian Civil Code — to the rights on things. On the other hand, commercial pledge law was from the very beginning considered as a part of the Commercial Act and initially was even included as part VII of the drafted Commercial Code of Latvia. However, later on, it was adapted as an independent law and now is not even included in the latest version of the Commercial code. The Latvian Civil Law Act distinguishes three different modifications of pledge:

- the so-called hand pledge, which is in fact a deposit of personal property as security for a debt;
- mortgage, which is related to the pledged real property;
- usage pledge of an immobile fruit bearing item, which is pledged so that the creditor has possession of it, and obtains the fruits of it.

Due to these definitions by the Civil Law Act, the authors of the Commercial Pledge Act were faced with the need to distinguish the commercial pledge from both the so-called hand pledge and mortgage.

On the one hand, commercial pledge as an institute dealing mainly with items of personal property has some similarity with the pledge as such (hand pledge). On the other hand, commercial pledge was designed to avoid handing over of the item by the grantor of a pledge (pledgor) to the person who accepts a pledge (pledgee), which inevitably makes commercial pledge similar to mortgage.

It was absolutely necessary to resolve this problem also because the implementation of the principles introduced by the Civil Law Act faced extreme difficulties in practice, especially in connection with the stated necessity to deliver the object of the pledge in actual possession of the pledgee. Interpretation of the above principles of the Civil Law Act caused hard times for the judges, especially because the Civil Law Act gives a very wide interpretation of what would be regarded as an actual possession of the item of personal property.

In practice it led to the situations that sometimes it was extremely difficult to find out who actually held the pledged item, especially if a pledgee allowed the thing to remain with the pledgor who then could be regarded as an agent of the pledgee. This, unfortunately, from time to time led to intolerable situations. For instance, one who already had granted his personal property as a pledge to another person and with a consent of the pledgee kept this property in his custody as an agent of his own pledgee, soon stepped into the pledge agreement with another person by granting the same property as a pledge again. In court practice of the early nineties it was found that sometimes all belongings of companies served as a pledge to different banks, even on as many as four consecutive occasions. No wonder that in the given situation banks were the main subsidiaries in promoting the Commercial Pledge Act.

The Commercial Pledge Act was adopted on 21 October 1998. The Act modified the principles of the pledge right under the guidelines set by the Civil Law Act.

According to section 2 of this Act, a commercial guarantee is a pledge, which, following the procedure determined by the Act, is registered in the commercial guarantees register. The Act also stated that the general provisions of the pledge right as set forth in the Civil Law Act should be applied to commercial guarantees insofar as the Act did not provide otherwise.

The new Act stated that the subject of a commercial guarantee could be any movable object and even an intangible object, which belongs to an enterprise, as well as the aggregation of the objects including all the property of an enterprise (entrepreneurial association).

This was a big step forwards as compared with the Latvian Civil Law Act, which in fact covered only tangible things but intangible things could become a subject of a pledge right only if actual possession of the thing by a pledgee was possible. Thus, although intangibles could become a subject of a pledge right in principle, necessity to prove that the intangible thing in question was in the possession of a pledgee, made implementation of this principle extremely difficult and caused a lot of disputes in practice.

However, substantial assets still could not be a subject of a commercial guarantee, a vessel or securities in public circulation as well as the claim arising from a check or a promissory note could not be a subject of a commercial guarantee.

Even if all the property of an enterprise is pledged or an obligation of objects is pledged, the above-mentioned items shall be considered as excluded from the pledged property.

It is not a very big surprise as well that we find very tough restrictions on imposing commercial pledge under this law. Being a reaction to the horrors of the early nineties, these restrictions could also be treated as an over-reaction. Given that commercial pledge like mortgage has to be duly registered in the Centralised Commercial Guarantees Register, one could see no danger in registering several consecutive commercial pledges in the same item of personal property if it is valuable enough. And a consecutive pledgee has to be aware about the status of the item, which is already registered in a publicly available register as an item of somebody else's pledge right.

However, the Latvian Commercial Pledge Act prohibits such repeated granting of an item as a second pledge. A special amendment to the Latvian Criminal Code, which was introduced as a package of amendments in current Latvian laws when the Commercial Pledge Act was passed, qualifies such action as a crime.

It must be pointed out that, notwithstanding the above shortcomings, the Commercial Guarantees Act was a big step forwards, covered a lot of unsolved problems, and it is working in practice. A lot of subjects, however, are not covered by this law and are still regulated only by the Civil Law Act. This relates first of all to immovables, given that restoration of the Land Register Act and the Recording Real Estate with Land Registers Act was adopted shortly after the Civil Law Act came into force. Mortgage rights can be registered easily, and this institution is functioning relatively well.

Some difficulties in court practice arose only in connection with immovables which, at the time when they were used as a security, were still unregistered in the land books. This caused some confusion in practice, which sometimes led to curious situations where a land unit was treated as a movable thing. However, the inherent contradictions, such as dual attitude towards land and buildings (see chapter 2.1), and proposed ways of solution of these difficulties have had a huge impact on mortgage rights. For instance, both owners — the one of the land and the one of the building have the right of

refusal if the other party decides to alienate its right in the immovable. It is unclear how and when such right of refusal can be implemented, if the immovable is pledged and the pledgee faces the necessity to sell the property.

Another problem is that mortgage rights stated by the Civil Law Act do not fit very well with the procedure of the auction of real estate as stated in the Civil Procedure Act, which sometimes in practice leads to situations when the mortgagee finds himself circumvented by other claimants, who had either weaker or later claims but were smart enough to use shortcomings of the Latvian Civil Procedure Code in their favour.

## 4. Protection of Foreign Investments

The Latvian Foreign Investment Act defines foreign investment as a long-term investment in the basic capital, separated by foreign investors for performing entrepreneurial activity in the Republic of Latvia.

According to section 8 of the Act, the Republic of Latvia ensures the protection of foreign investments. The compulsory alienation of foreign investments by the Republic of Latvia may only be carried out in accordance with a specific law, adopted pursuant to the Republic of Latvia 15 September 1992 Eminent Domain Act.

It has to be underlined that bilateral agreements, which are concluded between Latvia and nearly all economically developed countries of the world, define investment differently than the above-mentioned Foreign Investments Act. These bilateral agreements usually state that the term “investment” shall mean any kind of property invested by a natural or legal person of a contracting party in the territory of the other contracting party.

Such wider definition of the investment is also approved by Latvian practice of implementation of the law, as well as in international disputes.\*<sup>1</sup>

According to this principle the only condition, which must be met by a foreign investor, is that investment must be carried out in the territory of Latvia. For this reason expenditure by foreign investors, which was carried out abroad, like payments for drawings, design, patenting, *etc.* are not accepted as investments unless they are turned into real construction or industrial works on the territory of Latvia.

Such kind of disputes from time to time arise in connection with the privatisation process, sorting out\*<sup>2</sup> whether subjects of privatisation, which frequently happen to be of foreign origin, meet the conditions stipulated by the purchase agreement of the Latvian enterprise.

<sup>1</sup> See Arbitration Award in the matter of an arbitration under article 7 (2) of the Agreement between the Government of the Kingdom of Sweden and the Government of the Republic of Latvia on the Promotion and Reciprocal Protection of Investments between Swembalt AB, Sweden, and the Republic of Latvia, dated 23 October 2000. Available at: <http://bnsnews.bns.lv/1234>.

<sup>2</sup> Privatization of hotels spa to be terminated. – The Baltic Times, 17 February 2000. See also Kemeris spa privatization stays in force. – The Baltic Times, 16 March 2000.