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# Latvian Contract Law and the EU

Contract law has for centuries promoted international trade and complied with the necessities of international economic relations. As a result of tight integration of EU countries, breaking of obstacles for free movement of capital, goods, services and labour, new trends are appearing in contract law. Latvia, in accordance with the decision made by EU Council in Helsinki, in December 1999, has already commenced discussion on entry into the EU. Significant work has already been accomplished for the harmonisation of the law of Latvia with the law of the EU. However, the EU does not require complete unification of the law. The law of each country has differences and such differences shall remain. Law is a rather conservative social category and therefore when talking about common law, the peculiarity should be taken into consideration. Even one legal regulation, for example, on the moment of concluding a contract or on a right to terminate a contract can cause disputes and conflicts during the execution of the contract.

Generally Latvian private law belongs to the community of law of continental Europe, however we all know that even the law of Germany and France may not be acknowledged as identical. The European Union includes both countries with continental European law and common law systems. In practice that still does not trouble economic relationships too much. Endeavours to bring closer the aforementioned systems should be appreciated. Principles of International Commercial Contracts drafted by UNIDROIT and Principles of European Contract Law recently finalised by the Lando Commission show that at least theoretical progress may be reached in this area. Meanwhile, it can be predicted that implementation of theoretic conclusions in specific legal acts shall require a long time period. However, in some cases an elaboration of such principles can turn the interpretation of already existing legal regulations in another direction. It appears more often in Common Law countries, but can also happen in the countries of continental Europe.

## 1. Variety of contract types

Matters of concluding and execution of contracts, as well as general principles of liability are subject to the Civil Law of the year 1937 reintroduced in parts in 1992 and 1993 respectively.<sup>\*1</sup> Since the reintroduction, the 4<sup>th</sup> part of the CLA has neither been amended nor perfected. However, many other laws have been adopted, which detail and develop specific types of contracts within the limits and basis of general principles of CLA. Several laws and regulations of the Cabinet of Ministers can be

<sup>1</sup> Civil Law [The Civil Code]. Ed. by the Latvian Law Institute. - Latvian Law Library: Vol. 1. Stanford, Connecticut USA: Government Law Systems, 1998. Further in the text also — CLA (Civil Law Act).

mentioned, which, beside other transport related issues covered by them, regulate carriage as well. They are: Latvian maritime rules (Maritime Code) and Aviation Act, both adopted in 1994, Cargo Act, adopted in 1995, Road Traffic Act, adopted in 1997 and Railway Shipping Act, adopted in 2001. During preparation of the said laws, provisions on transport were harmonised with the Convention on the Contract for the International Carriage of Goods by Road (CMR) of 19 May 1956, and the Convention on the Contract for the International Carriage of Passengers and Luggage (CVR) of 1 March 1973. Latvia joined the aforementioned conventions by adopting the laws in December 1993.<sup>\*2</sup> Unlike carriage, the Vienna Convention on Contracts for the International Sale of Goods, which Latvia joined by adopting a law on 19 June 1997<sup>\*3</sup>, is not incorporated in the national law of Latvia. Similarly, UNIDROIT conventions on international financial leasing and international factoring<sup>\*4</sup> are not incorporated in the national law. By adopting the Consumer Protection Act (18 March 1999)<sup>\*5</sup> complying with the standards of Europe, four specific consumer contracts came into legal force, regulation of which is detailed in the Regulations of the Cabinet of Ministers. They are distance contracts, doorstep sales, time-sharing and consumer credit contracts. Separate laws detail provisions on rent of residential dwelling, land lease, labour contract, contracts in respect of intellectual property and other. The Insurance Contract Act (10 June 1998)<sup>\*6</sup> is significant for the issues covered therein. It is important that elaboration of laws in recent years has been performed in due compliance of respective EU directives and international conventions. Experts from the EU frequently participate in the preparation of legal acts. Now and then unusual legal constructions can be faced. For example, in accordance with the tradition of Latvian legislation, obligations and liability usually are included in the same law. In 1996, the *Saeima* (Latvian parliament) approved the Safety of Goods and Services and Liability of Manufacturers and Service Providers Act<sup>\*7</sup> with EU regulations included of course. However, several experts questioned whether such "Latvian" treatment observes and includes completely entire terms of respective EU directives. As a result on 20 June 2000, the *Saeima* adopted two new laws: the Safety of Goods and Services Act and the Liability For Deficiencies of Goods and Services Act. Thus, in this sphere Latvia has harmonised with the EU not only by content but also by the number and form of laws. However, Latvia has introduced a surprise-worthy novelty by including in the Consumer Protection Act a provision acknowledging not only an individual as a consumer, but a legal entity as well, if the legal entity has acquired goods or services for no direct entrepreneurial purposes (section 1 of the Act). The existence of such a "national feature" may not be anticipated, but execution of the said provision will cause problems.

Legislators are working on the adoption of the Commercial Act in accordance with the approved concept providing also for a section on Commercial Transactions. The *Saeima* adopted the first three sections of the Commercial Act on 13 April 2000.<sup>\*8</sup> Those regulate: (1) general rules of commercial activities, (2) types of entrepreneurs (individual entrepreneur, personal companies, capitalised companies), (3) reorganisation of commercial companies. The said Act, as well as the Implementation Act of the Commercial Act aroused extensive discussions, during which it was often emphasised that implementation of the law would cause significant expenses, also several novelties bringing Latvia together with the EU were questioned. However, the work accomplished must be valued positively, although it can be acknowledged that it should have been done earlier as it was done in Estonia. A concession contract is one of the recent types of agreements introduced by Latvian law. Such a contract is provided by the Concessions Act<sup>\*9</sup> adopted on 20 January 2000. It is still questionable whether the aforementioned Act fits into the existing system of contracts but it can be useful in the case of uncovering overland oil deposits of commercial use. Certainly, conclusion and execution of contracts is affected by the Competition Act (18 June 1997), the State and Municipality Order Act (24 October 1996) and others as well. In practical business in Latvia not only contracts formalised by CLA, but also so-called "modern" contracts are used. No law mentions contracts like franchise or monitoring, however they are used in practice. That is promoted by legal provisions of the Introductory Part of Civil Law allowing parties to choose the most appropriate solutions with one restriction — they may not contradict with imperative and prohibitive provisions of Latvian law. On 19 June 1997, the *Saeima* adopted laws on joining UNIDROIT conventions of 1988 on international

<sup>2</sup> Latvijas Vēstnesis (hereinafter: LV), 12.01.1994, 15.01.1994.

<sup>3</sup> Zinotājs, 1997., nr. 15

<sup>4</sup> Zinotājs, 1997., nr. 16

<sup>5</sup> Zinotājs, 1999., nr. 9

<sup>6</sup> Zinotājs, 1998., nr. 15

<sup>7</sup> Zinotājs, 1996., nr. 21

<sup>8</sup> LV, 04.05.2000.

<sup>9</sup> LV, 02.02.2000.

financial leasing and international factoring. That favours implementation of the said types of contracts according to those known world-wide. However, it must be noted that there are a number of other contracts called “leasing” several of them corresponding more with purchase on an instalment plan or long-term lease with buy-out. By adopting the new Civil Code on 18 July 2000, Lithuania decided to include several so-called modern contracts (financial leasing, factoring, distribution) in the law and on at least minimal regulation of them. This experiment deserves detailed analysis of the practice of implementation of the law in the future since, as we know, many Western countries have not come to an understanding on the point of the matter and variations of such contracts. Few sources indicate, for example, 28 subspecies of leasing and apart from financial leasing, an operative lease is acknowledged as well. Therefore a situation may arise when definitions introduced by the law limits the initiative of parties regarding their use of legal constructions. However, disclosure of modern contracts in the code gives positive effect as well.

By summarising this survey, it can be concluded that the eighteen types of contracts mentioned in the Civil Law do not reflect the variety of contract practice. Therefore, it is now more important to perfect the general provisions on contracts of the Civil Law rather than detailed regulation of each contract type known.

## 2. The reform of the court system and improvement of the court practice

As of the year 1992, a judicial reform for ensuring the execution of laws and the improvement of dispute litigation has been implemented in Latvia. Appeal and cassation proceedings have been introduced.<sup>\*10</sup> The new Civil Procedure Act, adopted on 14 October 1998 and effective as of 1 March 1999, replaced the Civil Procedure Code<sup>\*11</sup> initially adopted in 1963 during the Soviet regime and amended frequently afterwards. Laws on judicial reform and civil proceedings have not ensured everything that is necessary for courts: premises, computers and a sufficient number of judges. Therefore, courts are often reprimanded regarding slow work, as well as about quality of verdicts. The annual publications, which commenced in 1997, of the Supreme Court’s verdicts and decisions promote the transparency of court performance. The first collection reflecting work of the District Courts in 1999–2000 has been published also. Gradually standing courts of arbitration established in Latvia — and there are 12 at the moment — are becoming more and more popular. Also a choice of courts of arbitration located in other countries for dispute settlement has become common.

When analysing the court practice in respect to fulfilment of contracts and liability it must at first be noted that Latvia, similar to other post-communist countries, experienced a so-called period of accumulation of initial capital. After independence was regained, an atmosphere of exaggerated permissiveness dominated in business when each and every individual, state enterprise and even municipality was allowed to earn money by using all possible means. As it was discovered later, during that time many loan agreements were concluded without sufficient collateral and even with fictitious companies. Guarantees were issued (also for remuneration) and property, including property of state and municipality, was pledged with generosity. When the first restrictions on accepting deposits from individuals were imposed, trust investment and capital management companies boomed. A typical feature of the first decade of independence was abnormally high interest rates, often accompanied with very severe contractual fines. Some disputes related with the aforementioned transactions are still in court hearings even in the year 2001. However, if evaluating CLA and searching for difference in comparison with law of other countries, the following few material features are worth mentioning.

In the event of overdue repayment of debt, Latvian CLA provides for a possibility to require interest, as well as a contractual fine and recovery of damages (CLA section 1722). The rate of legal interest is 6% *p.a.*, but parties may agree on a higher interest rate in an agreement. The extent of contractual fine is not limited either. Unlike German *BGB* (section 343)<sup>\*12</sup> or UNIDROIT Principles of International Contracts<sup>\*13</sup>, Latvian courts are not entitled to reduce the contractual fine payable if and on a basis of being too excessive. There have been rather many disputes caused by uncertain formulations

<sup>10</sup> Law On Justice (15.12.1992.) - Zinotājs, 1993., nr. 1/2

<sup>11</sup> Zinotājs, 1998., nr. 23

<sup>12</sup> Bürgerliches Gesetzbuch. 38. Aufl. Beck — Texte im dtv.

<sup>13</sup> Principles of International Commercial Contracts. Rome: International Institute for the Unification of Private Law (UNIDROIT), 1994.

used in agreements; for example, in the event of delay the respective party pays a late charge (or penalty) of 0.5% per day. In the event of default, one party usually asserts that a contractual fine was contemplated while the opposite party understands it as interest for use of foreign capital. The difference is essential: if the provided payment is an interest, accumulation of such ceases when 100% of the capital is reached. If the provided payment is a contractual fine, than the accumulation of sum does not stop at 100% margin, moreover, the creditor is entitled to request for the legal interest — 6% *p.a.* as well. On 22 December 1997, the General Meeting of the Supreme Court adopted a decision on application of law when deciding on disputes on fulfilment of obligations, interpreting that in the event the will of parties may not be certainly determined, section 1509 of CLA must be followed providing, that in the event of doubt, a transaction should be interpreted to the detriment of the party being a creditor and therefore should have expressed itself more precisely. Disputes on guarantees and powers of representatives, as well as on rights to unilateral termination of agreement occupy a significant part of court practice. Among the disputes heard by the court, disputes on repayment of credits, payment of purchase price and similar should be singled out. In those cases defendants often challenge the validity of the agreements, arguing that its representative was not authorised to enter into such agreements on behalf of the defendant. For example, it is indicated that a vice-president was not entitled to sign an agreement without obtaining prior authorisation or that the agreements above the sum stipulated by the charter could have been concluded on a basis of the board's decision only, or that in accordance with the charter, agreements had to be signed by two representatives acting together. In some cases such arguments allowed escape from a contractual fine and the court was of the opinion that only repayment of the received money or restitution should be ensured. The amount of disputes on the aforementioned basis will decrease since the Commercial Act provides for more detailed regulation of the representation authority of the board of joint stock companies and limited liability companies.

Sections 223 and 303 of the Commercial Act provide as follows: a company is represented by all board members together unless a charter of the respective company provides for individual or joint representation of several members of the board. Individual or joint representation of several members of the board of a company creates binding contracts only if such representation is explicitly included in the charter of the company and registered in the commercial register.

By adopting the Commercial Act, a procuracy — a new type of authorisation (proxy) has been introduced into the legal practice of Latvia. A procuracy is a commercial authorisation which grants to a procurator the right to conclude transactions and to perform other legal activities connected with any commercial activity in the name of the entrepreneur, including all procedural activities during the course of legal proceedings (motions, settlements, appeals of court judgements, *etc.*). A procurator may alienate, pledge or encumber real estate only if he or she has been especially granted those rights (section 34 of the Commercial Act). Limitations of the extent of procuracy are invalid relative to third parties (section 36 of the Commercial Act). This will reduce the amount of disputes conferred on the extent of authority. In other cases, when an attorney-in-law questions the rights to submit appeals of court judgement or participate in a court hearing, objections may not arise if the attorney-in-law is claiming for due compliance of the law.

### 3. Specific features of Latvian contract law

Research into the differences of Latvian contract law in comparison to the law of other countries, revealed a few noteworthy matters. First, foreign investors should pay attention to the fact, that in Latvia an agreement between absent partners is concluded upon the moment when a party which has received an offer dispatches an acceptance even though the opposite party has not received it. On the contrary in Germany and several other countries the so-called "P.O. box principle" has been accepted — agreement is concluded as of the moment acceptance is received by the addressee (in its post office box). With the development of e-trade this difference becomes less important or even disappears. Besides large transactions are not usually concluded by an exchange of letters. However, in some cases a lack of knowledge of law may cause negative legal consequences.

Second, foreign lawyers consider section 1587 of CLA, corresponding to the maxim of Roman law *pacta sunt servanda*, as an excessive manifestation of formalism. Foreign lawyers could be right unless the said principle had not been repeatedly mitigated in other section of CLA. In court disputes section 1587 is quoted frequently: "A lawfully made contract commits the contracting party to carry out a promise and neither the burden of the transaction nor difficulties of execution occurring later shall entitle one party to back out of the contract even if compensating for loss and damages." However, when becoming acquainted with the entire text of CLA, several exceptions can be mentioned certifying that similar to other countries a flexible approach is possible in Latvia as well. Certainly, *force majeure* and accident excuses non-fulfilment of a contract. A contract may remain

unfulfilled due to the nature of the contract requiring certain activities from the opposite party (for example, if a land plot for construction purposes is not allocated, a letter of credit is not issued) or when it is especially provided for by the law (CLA section 1589). If due to the fault of the debtor, the creditor is not interested any more in the fulfilment of the agreement, the latter may claim for cancellation of the agreement (CLA section 1663). Chapters on specific types of contracts provide for various exceptions. For example, purchase and lease contracts may be claimed to be cancelled due to excessive damages caused (CLA sections 2042, 2170). Further grounds for cancelling lease and rental agreements are listed in sections 2171 and 2172 of CLA.

Third, the doctrine of Latvian law does not permit non-fulfilment of a contract if such non-fulfilment complies with the public policy. However, even in the USA and England in such case the debtor is under an obligation to recover damages caused. The difference is that the USA considers such non-fulfilment of contract to be legal, while Latvia — immoral, but the financial consequences for the persons involved are similar. There has been no attempt in Latvian courts to argue on the grounds of frustration of the purpose of the contract and there is no reference in the law on that. Supposedly, a new provision should be included in the Civil Law, similar to the one of section 248, Book 6 of the Civil Code of the Netherlands. Under the said section when discussing consequences of the contract, considerations on reasonability and fairness must be taken into account. It might not be done in a hurry since the opinions of Latvian judges on reasonability and fairness may be essentially different.

Fourth, the Civil Law does not provide for any pretext on limitations for recovery of damages, which could be predicted as on the date of concluding the agreement (UNIDROIT Principles art. 7.4.4). This legal provision is effective in cases where the dispute is subject to CISG regulation. In the draft of the Commercial Act's Transaction Section the said principle is included as a general legal provision.

Fifth, in Latvian legal theory and practice the category “remedies” is used very seldom. In the Civil Law the word “remedies” is used only once (in the heading before section 1619) when consequences of selling non-qualitative good are discussed. But most frequently — Latvian lawyers speak about liability in default; which, of course, is not the only issue. Other consequences of default may not be forgotten. Section 1620 of CLA mentions remedies as reduction of price and repeal of contract. Consumer Protection Act provides for remedies as exchange of non-qualitative goods for qualitative or equivalent ones and elimination of deficiencies free of charge (section 28). Application of the Vienna Convention of 1980 (CISG) will promote Latvian lawyers to turn more to the matters of liability as well as to protection of rights in general.

In the sixth place, Latvian law does not contain legal provision on “cover” in cases of late delivery of goods. However, the Civil Law allows to act similarly complying with the set sequence. In the event of delay, the purchaser must notify the contracting party that the purchaser has lost its interest in the receipt of goods since the goods were necessary immediately. After the said notification and on the grounds of the contracting party's breach, goods may be purchased from another seller and the price difference may be recovered from the defaulting party. Theoretically, a dispute on whether the purchaser has lost its interest may be raised. Therefore, section 1663 of the Civil Law should be amended to cover the aforementioned situation as well.

Study of foreign law and court practice confirms more and more clearly that the same principle may be expressed in different formulations and placed in different places of the legal system. The Latvian Civil Law is constructed by following the chronology of forming and development of legal relationship: conclusion of agreement, conditions for legal validity of agreement, execution, amendments to or termination of the agreement, liability and other consequences of non-fulfilment. In the said aspect the category “remedies” includes liability as well as amendments to and termination of agreement, which are not always connected exclusively with breach. In Latvia the prevailing opinion is that liability as a consequence of illegal performance must be separated from the issues related to amendments to or termination of contract. However, one cannot deny that amendments to or termination of contract could be a result of illegal performance. Therefore there could be no grounds for dispute of which is a more correct approach; both have good arguments.

The aforementioned confirms that there are no huge differences among laws of different countries, especially between the systems of countries of continental Europe and common law. Such opinion is exaggerated. Development of international business contacts certifies that not only lawyers can understand each other but businesspersons without specific education in law as well. However, it does not mean that differences have no meaning and that they may be ignored.

Work on improving Latvian law continues and the list of laws to be adopted by the *Saeima* is still impressively long. Such laws of national importance as Labour Act, Criminal Procedure Act, Purchase for State and Municipal Needs Act have been anticipated for a long time. Amendments to the *Satversme* (Constitution), which will be necessary for the incorporation of Latvia into the EU are also under elaboration. It seems that against such a background there is no time for the modernisation

of Civil Law and some time will pass. However, no serious politician or reasonable lawyer shall deny the necessity to think on a new reading of the Civil Law if Latvia intends to remain a country of codified law. There are rather many questions of civil law, which already appear in court practice and legal literature waiting for new and improved solutions. It will not be reasonable to try "to patch up" once so modern, but in present-day already comparatively archaic CLA. Similar to Lithuania and Estonia a new contract law section should be elaborated. At this time the comparative research of rules and directives of the EU and other countries dominates in a process of drafting laws in order to adopt solutions corresponding and fitting in the legal system of the state. When all the Baltic States struggled for the regaining of independence, an idea was advanced on the forming of a joined economic region and harmonisation of laws. Due to different circumstances the aforementioned idea was not implemented. Probably a new chance to harmonise or even to unify the contract law of the Baltic States has appeared on a basis of contract law of Lithuania and Estonia elaborated with the assistance of foreign experts.