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ARTICLES

Russia's Intractable Economic Problems and the Next Steps in Legal Reform: Bankruptcy and the Depoliticization of Business

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INTRODUCTION

In August 1998, the Russian government defaulted on its own debt, ordered private borrowers to default on foreign loans, and provoked a collapse of the country's banking system. The government also abandoned its support of the ruble. The ensuing monetary crisis reflects the state of the Rus-

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sian economy.¹ The value of Russia's currency, as with the value of anything, depends upon demand for it. Quite simply, there is not a great demand for Russia's currency, and the reason for that is that a ruble does not buy very much of what the world's consumers want. The monetary crisis revealed as never before the fundamental weakness of the Russian economy. The source of Russia's economic woes is its unique legacy of socialism—a legacy that has not died.

Russian socialism was an incredibly inefficient system, surviving for as long as it did through various means including access to abundant natural resources, dedication to the cause, and force. It is unfortunate that the system survived so long, because the Soviet Union's legacy is an economy that suffers from massive distortions. Such distortions greatly inhibit efforts to move to a market economy. Economic distortions in Russia, as with economic distortions anywhere, occur because the distortions are rewarded outside of or irrespective of competitive market forces.

Law reform in Russia proceeds on many fronts. This paper takes the position that the most important legal reforms for Russia are those that eliminate the reward system that encourages economic activity that can be highly inefficient. These legal reforms are an effective bankruptcy law and the de-politicization of business. The two go hand-in-hand. It is the politicization of business that renders Russia's bankruptcy laws ineffective by making non-viable business entities appear to be solvent. These two reforms, were they adequately implemented, would eliminate rewards for inefficiency. Only when the Russian government—and its people—have removed this reward system can conditions affirmatively conducive to growth be fostered and a business environment competitively attractive to foreign investment established. This position is by now uncontroversial, but the paper examines such reform in the context of the obstacles to its achievement.

I. THE LEGACY OF A COLD WAR SOCIALIST ECONOMY

The Soviet Union's demise left in its wake at least two enduring legacies. First, the Soviet Union bequeathed to Russia many inefficient and/or needless enterprises created to serve the socialist ideal. Second, the Soviet Union bequeathed to Russia citizens with a sense of entitlements, obligations, and ethics that is antithetical to a capitalist or market economy. Both of these bequests have proved to be substantial barriers to Russia's transition to a market economy.

¹ See Strobe Talbott, *Dealing with Russia in a Time of Trouble*, *ECONOMIST*, Nov. 21, 1998, at 54, 57 ("A nation's currency is a key manifestation and underpinning of its sovereignty – and its unity. This century has already shown that hyperinflation can destroy states, or turn them into monsters.").

A. The Value of Russian Enterprises

The Cold War was a war, and the Soviet Union lost. The implications of losing this type of war seem not fully to have been absorbed by many in the West. No enemy occupied Russia's territory and imposed a particular political, economic, and legal system. Therefore, the Russians have had to invent their own political, economic, and legal system. Some think that the current economic policy *caused* the troubles that prevail in the former Soviet republics. Although the policy might have exacerbated economic problems, it did not itself create the problems.

The Cold War was a war of nerves, fought on many fronts. Weapon build-ups and limited conquest followed by consolidation were manifestations. But the Soviet Union lost the Cold War economically, and lost it decisively. Before surrendering, countries that lose wars resort to desperate measures, the magnitude of that desperation dependent on the nation's determination to win the war. The Soviet experience in World War II certainly demonstrates its determination to win wars. In a "hot war," destruction of capital assets comes from without, e.g., from enemy bombs. One recalls photographs of factories and buildings reduced to rubble in post-war Germany. One now sees some of the same sights in the capitals of the former republics of the Soviet Union.² The economies of the countries comprising the former Soviet Union imploded.

The government of a nation that loses an economic war finds itself woefully short of resources for infrastructure maintenance. The Russian government simply lacks the necessary resources for roads, libraries, hospitals, education, etc. A walk through a post-Soviet city confirms this. Roads and sidewalks are allowed to deteriorate. There are few additions to libraries made after 1989. What were once manicured lawns of the campus of Moscow State University are now fields of weeds a foot high or more; the University's fountains are now empty basins.

The Soviet Union fought its economic war against capitalism. Capitalism, whether by design or by accident, is a system founded upon the core principle that value should be maximized. Value is a measure of a consumer's willingness to pay for something or of an owner's willingness to sell something he/she already owns.³ When a consumer is willing to pay more for a good or service than its actual price, the excess is surplus value. When a seller sells for a price greater than the lowest price at which it would be willing to sell, the excess is surplus value. In any transaction voluntarily entered, surplus value should be created for both purchaser and

² In Chisinau, Moldova, for example, the roofs of abandoned buildings in what should be the "high-rent" office district of the city are literally falling in. Yet no bombs fell on this city. The Moldovan economy simply is not productive enough to generate the funds necessary to maintain these buildings.

³ See RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 12 (5th ed. 1998).

seller. This surplus value contributes to the wealth of both buyer and seller. The wealth of a society is maximized when sellers freely compete *without interference* and *on a level playing field* to meet consumer desires. Sufficient competition compels sellers to identify consumer needs and desires and then to meet those needs and desires at the lowest possible price, which is the marginal cost of production. The freedom to enter markets that should prevail in a capitalist system assures that there is sufficient competition and that only those who can market products at a price that creates surplus consumer value can stay in business. Consumers, by the choices that they make, determine the goods and services that are produced and establish the prices that they are willing to pay. This market economy disciplines those who fail to create surplus consumer value. So long as demand is not artificially stimulated, e.g., by subsidizing production (or purchase) of one product so that it can be sold (or purchased) at less than its marginal cost of production at the expense of an otherwise superior substitute, productive resources should gravitate to their most valuable use. When there is no combination of uses of productive resources that would improve consumers' utility, there is allocative efficiency.⁴ Rigid adherence to the principle that competitive markets should be allowed to work assures maximization of consumer surplus value from the resources available. No political system achieves such efficiency, but hopefully deviations should neither be widespread nor without purpose. Deviations quickly result in sizable distortions as evidenced by the dislocations caused by *removing* an impediment to such efficiency.⁵

Socialism—whatever its ostensible virtues—proved to be a system that did not maximize value because the competition necessary to such value maximization was lacking. A centrally planned economy is not responsive to consumer demand⁶ and might be driven by very different considerations,

⁴ See MARK SEIDENFELD, MICROECONOMIC PREDICATES TO LAW AND ECONOMICS 53 (1996) (i.e., and more technically, when the slope of consumers' indifference curve and slope of production possibility curve are equal).

⁵ Upon U.S. approval in fall 1999 of China's admission to the World Trade Organization, garment workers complained that such admission would cost 150,000 American jobs. And Ross Perot, of course, may be most remembered for his observation in the 1992 presidential election campaign that a "giant sucking sound" would follow ratification of the North American Free Trade Agreement as American jobs were lost to Mexico. These "losses" really represent removal of significant distortions that impeded the working of the law of comparative advantage. Such distortions do not take long to develop, but seem to require considerable pain to remove.

⁶ See JOSEPH R. BLASI, MAYA KROUMOVA & DOUGLAS KRUSE, KREMLIN CAPITALISM: THE PRIVATIZATION OF THE RUSSIAN ECONOMY 27 (1997) ("In a free market economy, the managers of a factory depend on the market to tell them what to produce, and the profits of shareholders, the compensation of workers, and their own bonuses depend on the success of the business"); Special Section, *Freedom's Journey: A Survey of the 20th Century*, "The Strange Case of Karl and Adolf," ECONOMIST, Sept. 11, 1999, at 8, 9 ("Even the most brilliant bureaucrat could not consistently work out what product to make next, how much of it

e.g., national security.⁷ What consumer surplus Soviet-style socialism did create was relative only to the value created in transactions occurring in the Soviet Union's own closed, non-competitive system. Such a system creates *far* less wealth than a capitalist system. Central planning's blessing given to an inefficient producer is the means by which this shortfall occurs. The magnitude of the shortfall turns on the extent to which central planners claim a role in a nation's economy. In the Soviet Union, central planning was pervasive. The objective of the manager of an enterprise was not profit, but fulfillment of Gosplan's quota. The skills necessary to fulfill this objective had little to do with profit maximization, but had everything to do with obtaining necessary supplies.⁸ Soviet socialism could focus on some specific and rather narrow objectives, e.g., building and amassing weapons, saber-rattling, exploring space, and winning Olympic gold medals. Soviet socialism generated very little wealth for ordinary consumers. If Soviet socialism were capable of generating a comparatively significant amount of consumer wealth, it would not have collapsed. In Russia, seventy-five years spent without market discipline assured inefficiency on a massive scale.⁹ In fact, with rare exceptions, enterprises created less value than the value of the resources that they consumed.¹⁰

Former Prime Minister Yegor Gaidar has characterized the Soviet system as one of soft budget constraints and hard administrative constraints. On the one hand there was little concern with profit, but great concern with fulfillment of administratively-specified objectives. Failure to turn a profit would be compensated with subsidies, loans on easy terms, and tax arrears.¹¹ A capitalist recognizes that the Soviet system had it exactly backward. Value maximization requires hard budget constraints and soft administrative constraints. The fact that the Soviet government could not keep information concerning the wealth (as here defined) of citizens in thriving capitalist economies from its own citizens assured the demise of Soviet socialism. Increased demand by Soviet consumers for better prod-

to make, or how to make it more efficiently. The market is the only way yet found to conduct experiments about these things and to discover people's changing preferences. Command economies conducted no experiments and worked by ignoring preferences").

⁷ See Michael D.V. Coco, *Towards Enterprisation: Shareholder Rights and Economic Reform in Russia*, 39 VA. J. INT'L L. 169, 170 (1998) (for example, national security considerations might dictate siting a factory in Siberia, many miles from the site of raw materials, thereby increasing transportation costs).

⁸ See BLASI, KROUMOVA & KRUSE, *supra* note 6, at 27 (managers were often unaware of products' cost or whether plant made profit).

⁹ *Cf. id.* at 17 ("Though the Soviet economic machine could claim enormous industrial and agricultural output, it was very inefficient.").

¹⁰ See MAXIM BOYCKO, ANDREI SHLEIFER & ROBERT VISHNY, *PRIVATIZING RUSSIA* 33-38 (1995) (describing inefficiency of Soviet socialism).

¹¹ See Yegor Gaidar, *Lessons of the Russian Crisis for Transition Economies*, FIN. & DEV. (IMF), June 1999, available at LEXIS, News Library, Findev File.

ucts simply could not be met by such a system. Great quantities of bad or unwanted products, even when sold at low prices, do not create wealth.¹² In fact, paying the salaries of workers who produce unwanted goods is an implicit form of unemployment compensation.¹³

The first wave of privatization in Russia revealed graphically how poorly socialism performed compared to capitalism. Privatization of course involved selling off the productive assets of Soviet socialism. Purchasers of such assets could certainly foresee competition from others and from the West in an openly competitive environment in selling products to Russian consumers. The prices paid were stunningly low. Many, but not all, Russian firms were so inefficient that they were practically worthless.¹⁴ The "implied aggregate value of the Russian industry was under \$12 billion. That is, the equity of all of the Russian industry, including oil, gas, some transportation and most of manufacturing, was worth less than of that of Kellogg or Anheuser-Busch."¹⁵ There are various partial explanations for this, not least of which is that the manner in which privatization had to occur made the implied aggregate value of all Russian firms *appear* to be less than it really was. There was very little wherewithal to purchase equity interests in firms, resulting in depressed prices, although this is belied by the fact there was \$15 billion of capital flight in 1992.¹⁶ Workers and managers were permitted to buy their shares on the basis of a firm's "book value," i.e., the original cost of buildings, equipment, and assets—but not land.¹⁷ Presumably, such assets were worth more than their original costs, but maybe not. Worst of all, Russian socialism—with its extensive political interference in managerial decisions that are routinely made by private entities in capitalist countries—created a misalignment of the interests of profits and control.¹⁸ Shareholders, who should profit from their ownership

¹² Cf. Gregory Feifer, *Luzhkov's Guinea Pigs*, MOSCOW TIMES, May 16, 2000, available at LEXIS, News Library, Mostms File (thousands of autos produced by Moskvich and ZiL, irrespective of demand).

¹³ See Leon Aron, *A Second Go at a "Second Economic Revolution"?*, AEI RUSSIAN OUTLOOK 2 (Summer 2000), at <http://www.aei.org/ro/ro11988.htm>.

¹⁴ See BOYCKO, SHLEIFER & VISHNY, *supra* note 10 at 119.

¹⁵ *Id.* at 117. The largest employer in Russia, VAZ, a manufacturer of automobiles, sold for \$45 million. United Energy Systems, the utility owning most of Russia's power plants sold for \$746 million. See *id.* at 118. "...U.S. manufacturing companies have market values of about \$100,000 per employee. Russian manufacturing companies, in contrast, obtained voucher auction values of between \$100 and \$500 per employee. The difference is about 200-fold!" *Id.*

¹⁶ See *id.* at 119-20.

¹⁷ See BLASI, KROUMOVA & KRUSE, *supra* note 6, at 42.

¹⁸ See BOYCKO, SHLEIFER & VISHNY, *supra* note 10, at 120-21, who offer the following:

The most plausible explanation for Russian industry's low valuation lies in the theory of inefficient ownership and the misalignment of cash flow [i.e., profit] and control rights. Voucher auction prices reflected the values of the companies to outside investors, who received legal cash flow rights but ... relatively few control rights. The control rights

interests, in fact have very little power to control most corporations in Russia. In Russia, shareholders may have ownership interests, but control resides with managers¹⁹ who may divert assets for their own benefit. Great control powers also reside with local governments, especially when local governments have the will to keep non-viable firms in business.

The performance of socialism can be crudely compared to the performance of capitalism by noting the experience of Germany after reunification. West Germany and East Germany emerged from World War II devastated—but presumably in nearly identical conditions. Both had essentially the same quality and proportional quantity of human capital. When West Germany absorbed East Germany, not a single factory in East Germany could operate at the efficiency levels that consumers routinely demanded of western suppliers.²⁰ The German government has spent billions and will have to spend billions more to bring a major part of its economy to efficiency levels routinely assumed in the West.²¹ No doubt, this contributed to the electoral defeat of Helmut Kohl.

were held primarily by managers, who had an interest in value maximization because of their high ownership stakes, but had other interests as well.

The problem of managers simply diverting assets for their own use has not disappeared, although it has been reduced by privatization. In addition, to consolidate control against potential interference by outside investors, some managers cater to the workers who still own the majority of shares. Many Russian firms continue to pay for housing, child care, hospitals, schools and other services for their employees, a practice that is likely to continue unless managers stop needing worker support, or unless a better social safety net is provided by the government. When managers and workers join together to spend the profits of a company they control, outside investors are unlikely to have much left over. Perhaps most importantly, many companies are stuck with managers who lack the knowledge and ability to carry out restructuring, but who value their jobs too highly to leave despite their high ownership. . . .

Still, managerial discretion is probably not the whole explanation for the low valuation, since such problems also often exist in the West in a milder form. The low valuations suggest that the depoliticization of Russian firms has not been complete, and politicians maintain extensive control over companies. Even with sectoral ministries out of the picture, residual control enables politicians to expropriate shareholder wealth through regulations, restrictions on product mix and layoffs, custom duties and many other interventions, including the threat of potential nationalization. Continued politicization is surely the main reason that outside investors pay so little for Russian assets.

¹⁹ See BLASI, KROUMOVA & KRUSE, *supra* note 6, at 106-07 (describing management conduct to gain control of workers' shares).

²⁰ Cf. James Arnold, *Not the Real Thing*, BUS. CENT. EUR., Nov.-Dec. 1998, available at <http://www.bcemag.com/y1998/dez98/Cover/9812cover.htm> (noting that Avtovaz factory in Russia requires 450 man-hours to produce car; much better car produced in western Europe with 28 man-hours); Feifer, *supra* note 12 (Moskvich and ZiL require 30 times the worker-hours of western manufacturers to produce automobile, but labor costs 5% of labor costs in the west).

²¹ See Peter Gumbel and Carla Anne Robbins, *Rethinking an Empire: The New Russia*, WALL ST. J., May 28, 1996, at A1 (\$600 billion spent between 1990 and 1996; "torrent of funding" expected to continue for five to ten more years).

B. Soviet/Russian Citizens' Attitudes and Expectations of Government

The New Soviet Man did not materialize—at least not universally. Two significant characteristics of Russian people that the Soviet system *did* create (or perpetuate) were (1) a regard for laws and a sense of ethics, or right and wrong, that is at odds with that prevailing in the West in many respects, and (2) an aversion to risk coupled with a sense of entitlement to a wide array of social benefits well beyond those that citizens of most western countries expect.

1. *Business Ethics, Right and Wrong*

The labor theory of value of course held that the value of any good or resource depended on the labor necessary to produce or capture it. Value had no other source; value certainly could not be a reflection of demand for one resource relative to the demand for another and should not be measured through a common medium like money. With this as a basis of socialist social contract, Soviet socialism developed its own set of legal rules and norms of ethical behavior. This is *not* to say that everyone was ethical.

While socialism is a system designed to create equality, individuals, even those living in and indoctrinated in a socialist system, sought status and/or material possessions.²² Status could become the source of material wealth. During the Brezhnev years, if not before, much that was valuable that the economy might produce was taken (i.e., stolen) by those in a position to do so.²³ Many managers accumulated wealth by diverting to themselves or to friends factory output at the artificially low prices established by the state. Resale or export brought substantial profits.²⁴ Such behavior of course is quite inimical to the survival of socialism. Productivity levels in such an environment were quite low.

Perestroika was an effort to reverse this trend through compromise—much as Lenin's New Economic Policy was a mere euphemism for the creation of value through private enterprise in an economy that otherwise would not survive. During perestroika, rights of control devolved from politicians to enterprise managers. Giving managers a stake in the success of their enterprises should have prompted them to increase productivity and quality. Instead, such persons profited either from collecting bribes or diverting the

²² See Leon Aron, *The Strange Case of Russian Capitalism*, AEI RUSSIAN OUTLOOK 2, Winter 1998, available at <http://www.aei.org/ro/ro8906.htm> ("Ferocious individualists, jealously protective of their private space, resourceful and wily fighters for personal amenities – [Russians] were at once dependent on the state for everything and deeply resentful, cynical, and hostile to it ...").

²³ See BOYCKO, SHLEIFER & VISHNY, *supra* note 10, at 37-38 (managers with rights of control but no rights to cash could accumulate wealth by collecting bribes); ROSE BRADY, KAPITALISM: RUSSIA'S STRUGGLE TO FREE ITS ECONOMY 49 (1999) ("thievery and bribery.")

²⁴ See BLASI, KROUMOVA & KRUSE, *supra* note 6, at 34 (extent to which factory managers took advantage of their positions may never be known).

output of their factories;²⁵ the problem of corruption actually grew worse during perestroika. Soviet ethics did not *function* to enhance consumer value as business ethics should do in market economies.²⁶ Soviet ethics failed to develop sufficiently pervasively to make the system survive.²⁷ And then perestroika changed the whole ethical construct of Soviet society.

The legalization of private enterprise in the late 1980s became a major source of widespread ethical confusion. Communist philosophy did not recognize the existence of private property or profits, yet both became legalized, and even mandated, by Soviet and Russian laws . . .

This chaotically-evolving legal structure gave little direction to people engaged in business. Individuals had to define for themselves the proper conduct in business relationships. These business people came from different backgrounds and often held different values . . . Some business people were guided by the values and accepted practices of the former communist system, others by universal values or religious beliefs, and others by criminal and unscrupulous motives. Still others, lacking experience in a market economy, simply were ignorant of what constituted ethical behavior in such radically new and uncertain circumstances.²⁸

Corruption has thrived in such an environment. It is a part of the Soviet legacy.²⁹ As *The Economist* noted, "Russia has been, more or less, an orderly country for much of its history. But it has practically never been lawful."³⁰

It took over seventy years to develop such a business culture; it is certainly not an entrepreneurial culture.³¹ Realistically this culture will not

²⁵ See BOYCKO, SHLEIFER & VISHNY, *supra* note 10, at 38-43.

²⁶ For example, business ethics – as well as the Federal Trade Commission Act and consumer protection statutes in most states – would hold that sellers should not falsely advertise their products. Such rules serve the objectives identified here as those of a market economy, i.e., maximizing consumer value, in that consumers should not be duped into sending false signals regarding their preferences to sellers.

²⁷ See Aron, *supra* note 22 ("Decades of contest with unjust and often irrational rules turned Russians into a nation of lawbreakers.").

²⁸ See Sheila M. Puffer & Daniel J. McCarthy, *Business Ethics in a Transforming Economy: Applying the Integrative Social Contracts Theory to Russia*, 18 U. PA. J. INT'L ECON. L. 1281, 1287-88 (1997).

²⁹ See Scott P. Boylan, *Organized Crime and Corruption in Russia: Implications for U.S. and International Law*, 19 FORDHAM INT'L L.J. 1999, 2004-05 (1996) (criminal groups already existed at time of communism's fall; understanding black market under communism key to understanding difficulty of transition to market economy).

³⁰ *Russian Organised Crime: Crime Without Punishment*, ECONOMIST, Aug. 28, 1999, at 17, 18.

³¹ See Andrei A. Baev, *Implications of Emerging Legal Structures for Capital Markets in Russia*, 2 STAN. J.L. BUS. & FIN. 211, 215 (1996) (observing absence of such a culture); Christopher F. Dugan & Vladimir Lechtman, *The FCPA in Russia and Other Former Communist Countries*, 91 AM. J. INT'L L. 378, 378-79 (1997) (bureaucratic low salaries and declining living standard coupled with opportunities for bribe-taking and under-enforcement of applicable laws foster environment of corruption).

change in less than a generation.³² "Social attitudes and the relationship of an individual to the state do not necessarily change at the same rate as a governmental regime, particularly in an environment such as Russia's in which the fall of the old order has resulted in economic and social chaos."³³ The most effective way to hasten the abandonment of the Soviet mind-set and adapt to a market economy is to reach the oldest citizens who can still adapt to and understand a new culture. Probably that is college-age students.³⁴

2. *Russian Entitlements*

Seventy-five years of living under Soviet socialism created attitudes that did not disappear merely because the system disintegrated. Such a period created expectations on the part of Soviet citizens of their government. "After depriving generations of political liberty and economic and social autonomy, the Communist regime delivered to its successor not citizens but wards of the state."³⁵ Russians surely expect more from their government than those in the West expect from their governments. They typically had received, either from the government or from their employers, free health care, education, child care, and pensions. They received subsidies for housing and utilities.³⁶ These items are not typically provided free of charge by governments in the West. In the United States, the federal government provides incentives for individuals or their employers to provide at least some of these items through the Internal Revenue Code. Even if an employer provides them, they are a very real part of any wage package. Moreover, the employer must be that much more efficient in competing with those who do not provide such services; generosity does not reduce the rigors of market discipline. Furthermore, markets for *these* social services assure that they are provided efficiently and in a not overly-excessive quantity. In Russia, providing such services may be part of the contractual rela-

³² See *No Carrots*, BUS. CENT. EUR., Nov.-Dec. 1998, available at <http://www.bcemag.com/y1998/dez98/Survey/9812survey5.htm> (Russia persistently fails to abandon notion that "law is a means to coerce the people, rather than a mutual contract guaranteeing fair play for all").

³³ See *Coco*, *supra* note 7, at 173.

³⁴ As a Fulbright lecturer, I found college students to be *very* receptive to change, but frustrated by the obstacles they confront.

Rather than thinking of subsidies, the Russian government should be stimulating training and education of thousands of young Russians in the skills of restructuring, turnaround management, and bankruptcy workouts by sending them as apprentices to the regions of the major industrialized powers that have faced these crises. The Russian Government should be using foreign assistance to contract with the best universities in these countries to offer eighteen-month MBA programs in the restructuring of manufacturing concerns.

BLASI, KROUMOVA & KRUSE, *supra* note 6, at 180.

³⁵ See Aron, *supra* note 22.

³⁶ See Aron, *supra* note 13 (federal housing subsidy costs federal treasury 4% of GDP).

tionship between employers and their employees, but it seriously inhibits restructuring.³⁷

The trade-off that existed in the Soviet Union for most citizens was more security for less material wealth.³⁸ Importantly, Russian citizens often do not understand that there even was a trade-off.³⁹ They often have an idealized view of the West where opportunities, money, and superior products seemingly abound and are available to all.⁴⁰ Upon immigration, many of them have learned—either adjusting or failing to adjust—of the Western work ethic and Western norms of responsibility and accountability for oneself.

In Russia, there remains an unhealthy dependence on the state, coupled with an unhealthy aversion to risk.

Most Soviet workers are reluctant to make changes . . . The vast majority have grown accustomed to leaning on the state. They would rather settle for a meager wage and miserable living standards—and continue to complain about these shortcomings—than quit their jobs and take the chance of shifting to a cooperative with an uncertain future. They would rather pass up higher pay than take the risk of a cooperative's failure, or face the certain knowledge that they will have to work harder. Risk and uncertainty are things most Soviets habitually avoid like the plague.⁴¹

It is of course impossible to legislate attitudes. But it should be possible not to create a legal system and to maintain a political culture that rewards such misplaced dependence.

What material wealth Russian citizens could acquire when they were Soviet citizens they often acquired through relationships rather than through arms-length transactions reflecting choices of how to allocate their resources so as to maximize their own utility. People did favors for each other,⁴² and relationships of power and control grew out of such favors. Status mattered. The end of socialism destroyed the importance of many of

³⁷ See BLASI, KROUMOVA & KRUSE, *supra* note 6, at 142 ("Any restructuring of social services stirs serious conflict between the old culture of Russian enterprises and the new demand that they be competitive. It is not a small issue.")

³⁸ *Cf. id.* at 27 ("[E]mployees received modest wages with significant perks, such as enterprise-provided apartments, utilities, cafeterias, a day-care center and a kindergarten, health care, a vacation retreat, and a cultural center.").

³⁹ Private saving – certainly private saving of money – really had no part in such an economy. See *The Cash Don't Work*, *ECONOMIST*, Dec. 19, 1998, at 98, 99. Rather the state undertook to provide certain minimum levels of care from cradle to grave.

⁴⁰ See JANINE R. WEDEL, COLLISION AND COLLUSION: THE STRANGE CASE OF WESTERN AID TO EASTERN EUROPE 1989-1998 23-24 (1998) (observing that "the model of dependency on Big Brother, combined with ideas of Western prosperity, had formed the basis for aid expectations that would be difficult, if not impossible, to meet even under the best of circumstances").

⁴¹ See HEDRICK SMITH, *THE NEW RUSSIANS* 192 (1990).

⁴² See BRADY, *supra* note 23, at 21 ("Soviet citizens had lived their lives and improved their lots by engaging in endless informal barter deals").

these relationships on which productivity depended. With the demise of the importance of relationships also came economic decline.⁴³

II. PRIVATIZATION AND THE EMERGENCE OF THE RUSSIAN OLIGARCHS

Productive efficiency is the use of resources in such a way that outputs from those resources are maximized.⁴⁴ Necessary conditions of maximizing the value of productive resources are exclusivity, universality, and transferability,⁴⁵ i.e., interests in productive resources must be subject to exclusive ownership, all resources must be privately owned, and resources must be freely transferable. Privatization in the newly independent states represents an effort to (begin to) create these conditions. The principle of universality requires that privatization continue until the Russian government is involved in no more than providing social services.

Privatization in Russia was not (and is not) without opponents, notably from the communist party.⁴⁶ Anatoli Chubais had charge of the State Committee on the Management of State Property ("GKI"), the agency in charge of privatization. Mr. Chubais wanted to accomplish privatization as quickly as possible.⁴⁷ This was necessary in order to blunt the opposition of factory directors and government bureaucrats who naturally (and no doubt correctly) regarded privatization as a serious threat to their personal power.⁴⁸ Chubais sought to depoliticize the economy and assumed that Russians would respond to financial incentives the same way that citizens of other countries do.⁴⁹ "The progress of privatization was to depend on the pull of incentives and not the push of bureaucracy."⁵⁰ His program endeavored to take into account the interests of various stakeholders in enter-

⁴³ See ROBERT COOTER & THOMAS ULEN, *LAW & ECONOMICS* 218 (3d ed. 2000) (demise of Soviet system disrupted long-term barter relationships; failure of cooperation caused production to decline).

⁴⁴ See *id.* at 12.

⁴⁵ See POSNER, *supra* note 3, at 37-38.

⁴⁶ For a vigorous critique of the Russian privatization, see WEDEL, *supra* note 40, at 121-63 (describing the operation of the Russian privatization process and noting that Russian privatization benefited favored clans).

⁴⁷ See Virginie Coulloudon, *Privatization in Russia: Catalyst for the Elite*, 22 *FLETCHER F. OF WORLD AFF.* 43, 48 (1998). The desire for speed probably cost the government in that it precluded transferring ownership through cash sales. Cash sales would have required "valuation, information collection, preparation of auctions and public offerings and a variety of other services which investment banks gladly supply given ample time and generous fees." BOYCKO, SHLEIFER & VISHNY, *supra* note 10, at 71; see also BLASI, KROUMOVA & KRUSE, *supra* note 6, at 35-40 (describing competing political interests).

⁴⁸ See BLASI, KROUMOVA & KRUSE, *supra* note 6, at 45 (top managers and government bureaucrats in branch ministries opposed privatization from the beginning); BRADY, *supra* note 23, at 66 (factory directors enjoyed great power and feared change).

⁴⁹ See BRADY, *supra* note 23, at 66-67.

⁵⁰ BLASI, KROUMOVA & KRUSE, *supra* note 6, at 45-46.

prises—which resulted in *nomenklatura* privatization,⁵¹ a compromise (i.e., contradiction) of sorts that allowed directors and workers to acquire up to 51% of their enterprises on favorable terms.⁵² While Mr. Chubais's efforts to implement “shock therapy” were hardly without cost, it probably was the least costly way of pursuing, and indeed of achieving, privatization.

In the first round of privatization, employees and managers received substantial rights to acquire shares of their respective enterprises, and they quickly became the largest groups of shareholders.⁵³ Worker support of existing management⁵⁴ enabled managers to retain control, even when managers should have been replaced. These aspects of the first round of privatization plus some other contributing factors (e.g., distribution of non-voting shares, difficulty of re-selling shares, government's passive ownership of shares) made shareholder oversight of enterprises less than vigilant.⁵⁵ Management did not fear dismissal and had little incentive to maximize profits for the benefit of the enterprises's shareholders.⁵⁶ Significantly, this “voucher” privatization, which gave insiders control over firms, did not generate an infusion of much needed capital.⁵⁷ Firms' shareholders, i.e., workers, simply did not have the capital that their firms desperately needed.⁵⁸ Such privatization did nothing per se to enhance the capital of those firms desperately in need of it.

In the second round of privatization, the government planned to sell enterprises for cash—with part of the proceeds going to the enterprise and part to the government; the enterprises were also to purchase the land that they occupied. When it became clear that the government would not be able to raise the amount of money that it had planned, it postponed the auctions. In stepped a consortium of Russian banks who offered to lend the Russian government money in exchange for large blocks of shares in Russia's giant companies as collateral. As with any loan, the consequence of default is forfeiture of the collateral to the lender. Apparently the govern-

⁵¹ See BRADY, *supra* note 23, at 67 (notably employees and managers).

⁵² See *id.* at 71 (virtually guaranteeing that entrenched factory directors retained control of their plants).

⁵³ See BLASI, KROUMOVA & KRUSE, *supra* note 6, at 56 (employees of all kinds, rank-and-file and management, controlled 64.7% of privatized corporations in 1996); Coulloudon, *supra* note 47, at 47; see also BRADY, *supra* note 23, at 64-65 (“*nomenklatura* privatization”).

⁵⁴ See BOYCKO, SHLEIFER & VISHNY, *supra* note 10, at 112 (noting worker backing of managers).

⁵⁵ See Coulloudon, *supra* note 47, at 48.

⁵⁶ See *id.* at 48.

⁵⁷ Cf. Izak Atiyas, *Restructuring Programs In Transitional Economies*, in CHANGING POLITICAL ECONOMIES: PRIVATIZATION IN POST-COMMUNIST AND REFORMING COMMUNIST STATES at 195, 195 (Vedat Milor ed., 1994) (industrial restructuring “should be supported by a financial package that contains new resources; a reorganization of the liabilities of the enterprise, including redistribution of financial claims; and, often, debt relief”).

⁵⁸ BLASI, KROUMOVA & KRUSE, *supra* note 6, at 143 (“pretend capitalists”).

ment has defaulted.⁵⁹ The government gave those banks who participated in the "loan-for-shares" program special bidding privileges when the auctions finally did occur. Such firms could acquire a majority interest in such firms in auctions from which some interests, notably foreign interests, were excluded. The growing power of such banks enabled them to name the enterprises that they wanted the government to support.⁶⁰ The result was that various interests were able to buy stakes of desirable companies very cheaply. For example, Vladimir Potanin purchased a 96% stake in Sidanko Oil for \$530 million; two years later, he sold a 10% stake to British Petroleum for \$571 million!⁶¹ "Rather than creating competition, this 'privatization' transformed lucrative state monopolies into lucrative private monopolies,"⁶² i.e., financial industrial groups ("FIGs"), comprised of a financial institution and various industrial enterprises.

This "loan-for-shares" program had the consequence of distributing wealth in a particular pattern—i.e., to what has come to be known as an oligarchy—and of the government's surrender of economic power to this group.⁶³ This group obtained control of some of Russia's gems for very little money.⁶⁴ The reality was that exclusion of foreign interests made possible insider deals.⁶⁵ The fact that little money was raised in the process also meant that the government treasury did not benefit—and this inevitably makes difficult government efforts to implement any policy that might be beneficial. The wealth effects of the actual privatizations—concentration of wealth in the hands of a very few who are highly visible both in Russia and in the West and who remain well connected to government agencies—has created cynicism and disillusion.⁶⁶ But it is important to note: privatization

⁵⁹ See BRADY, *supra* note 23, at 206 (government's view is that shareholders have the right to sell their shares so long as they sell according to privatization law and they inform the government at least three months prior to sale).

⁶⁰ See generally BLASI, KROUMOVA & KRUSE, *supra* note 6, at 74-76 (describing loan-for-shares program); BRADY, *supra* note 23, at 135-43 (describing the loan-for-shares program); Coulloudon, *supra* note 47, at 49-50.

⁶¹ See Patricia Kranz, *International Business: Russia: Fall of an Oligarch*, BUS. WK., Mar. 1, 1999, at 44 (describing erosion of Vladimir Potanin's financial empire).

⁶² See WEDEL, *supra* note 40, at 152.

⁶³ See Coulloudon, *supra* note 47, at 50.

⁶⁴ See BRADY, *supra* note 23, at 140 (e.g., UnExim Bank won 38% of Norilsk Nickel for \$170 million, 25.5% of NorthWest Shipping for \$6.05 million, and 51% of Sidanko Oil Holding for \$130 million; International Financial Company won 14.8% of Novolipetsk Steel; Menatep won control of Yukos Oil Holding); Gary Peach, *The Analyst: Political Factors Dominate Redivision of Oil Industry*, MOSCOW TIMES, Nov. 16, 1999, available at LEXIS, News Library, Mostms File (1/3 of total national oil production sold for approximately \$1 billion).

⁶⁵ See BRADY, *supra* note 23, at 141 (comments of Vladimir Potanin).

⁶⁶ See WEDEL, *supra* note 40, at 132-33 ("privatization processes shaped the distribution of wealth in Russian society as well as citizens' perceptions of democracy and capitalism. Part of the public came to associate the terms 'market economy,' 'economic reform,' and 'the

did *not* diminish the overall value of the assets involved—it merely allocated them to some favored parties rather than to others.

Economic theory informs that when the value of productive resources is not maximized, free transferability of ownership interests will increase the value of those resources. Unfortunately, obstacles to transfers of interests in management/employee-owned firms or from the oligarchs has impeded such increases in value. It is *this* point that (now) causes economic stagnation in Russia much more than the original distribution of ownership interests.⁶⁷ Rather than transfer productive assets to more efficient owners, the present ownership structure of Russian assets is itself a source of power and personal wealth.

The oligarchs depend for their power on political connection, not market acumen:

[A Russian oligarch] sees business opportunities in terms of political contacts rather than new products, markets or services. He is an opportunist who cannot look beyond the short term. His understanding of capital markets, even of balance sheets, is close to nil. In the West, such a man might be a lobbyist or a fixer. He certainly lacks the ability to be a tycoon.⁶⁸

The oligarchs *may* control up to 50% of Russia's gross domestic product, but their political influence has proved to be the more significant.⁶⁹ *This* aspect of the oligarchy is what is so inimical to the Russian economy. The oligarchs receive rewards by relying on government to *perpetuate distortions* in the economy. Competition in Russia is in fact largely for government benefits that perpetuate economic distortions.⁷⁰ And the owners of such resources do not transfer them to more efficient users, nor are they taken over by more efficient users.

Neither monopoly nor oligopoly is a stable condition and maintenance of such conditions comes at a high price. While an oligarchy is not an oligopoly, the economic manifestation of the Russian oligarchy is high concentration in several industries that control much of Russia's most desirable resources. High concentration is not conducive to efficiency, but neither does a lack of concentration *necessarily* equate with efficiency. *The*

West' with dubious activities that benefited only a few people while others experienced a devastating decline in their standard of living").

⁶⁷ See Baev, *supra* note 31, at 216-17, 220-21 (1996) (commenting on effect of distributing shares to managers and employees); Andrei Baev, *The Transformation of the Role of the State in Monitoring Large Firms in Russia: From the State's Supervision to the State's Fiduciary Duties*, 8 TRANSNAT'L LAW. 247, 258 (1995) (management performance best judged by valuation of enterprise in a stock market, but "operation of an efficient stock market requires that ownership of the enterprise be transferable").

⁶⁸ See *Behind the Throne*, ECONOMIST, Sept. 12, 1998, at 76.

⁶⁹ See BRADY, *supra* note 23, at 208 (impossible to estimate actual level of control; power emanates from control of media).

⁷⁰ See Grigory Yavlinsky, *Russia's Phony Capitalism*, 77 FOREIGN AFF. 67-68 (May-June 1998) (oligarchs, not consumers, drive markets).

breakup of abusive economic power in Russia will occur through the emergence and growth of smaller, more efficient, and more competitive companies. What is necessary is that Russian governments, both federal and local, create conditions receptive to such companies. Creation of such conditions will take the form of not favoring the competitors of such companies, irrespective of the seemingly compelling reasons for doing so. Thus, a critical step that Russian governments, both federal and local, must take is to leave the forces of competition alone, i.e., not to intervene in the economy by favoring some—usually inefficient—enterprises over others. While concentration of Russia's Soviet generated wealth in the hands of a few may cause social unrest, such concentration did not increase or decrease the amount of wealth. As already noted, the value of Soviet era companies was quite low.

Ironically, the fiscal crisis of August 1998 may have the effect of compelling government to stop providing favors to politically well-connected oligarchs. By defaulting on domestic debt and allowing devaluation of the ruble, the government effectively stopped dispensing favors, i.e., subsidies,⁷¹ to the *banking* oligarchs—thereby exposing their greed and mismanagement. For now, at least *they* are in no position to go after distressed companies whose condition is attributable to the same crisis.⁷² The result could be either *further* concentration as *oil* oligarchs acquire more productive wealth—or a *reduction* in concentration as more nimble and efficient firms survive the crisis. Hopefully the weak ruble will favor the latter group.

III. RUSSIAN (IN)EFFICIENCY

Privatization effected a certain distribution of Soviet era wealth, but it did not create modern, efficient, valuable enterprises. Privatization has not alleviated the enormous economic distortions wrought by decades of central planning. Rather privatization has merely highlighted those distortions. The enterprises created under central planning still exist, even though the government may no longer own them outright. Often, privatization occurred factory-by-factory—with each production unit deemed a company to be sold.⁷³ These one-factory corporations are hardly the gems that the oligarchs sought, but they nevertheless comprise a very substantial portion of the Russian economy. Political and social forces have prevented necessary restructuring through merger, consolidation, or closure. Russia has countless enterprises that cannot make *money*, yet they stay in business. This is

⁷¹ See Brian Killen, *Feature – Russia Economy Improving Though Government Broke*, REUTERS NEWS RELEASE, June 30, 1999 (important that subsidies end).

⁷² See Kranz, *supra* note 61, at 44 (describing fall of oligarch Vladimir Potanin).

⁷³ See MCKINSEY GLOBAL INSTITUTE, UNLOCKING ECONOMIC GROWTH IN RUSSIA, *Cement* 3 (1999).

made possible by an economy founded upon barter, by bankruptcy laws that simply have not worked as they should,⁷⁴ and by local governments who work to perpetuate the system despite its shortcomings. This has come to be known as the "virtual economy."⁷⁵

In fact, many enterprises are so inefficient that the value of their outputs is less than the sum of the cost of inputs, e.g., labor, raw materials, taxes. These enterprises survive by paying their workers in kind, accumulating large tax arrears, and perhaps paying taxes in kind. These techniques are actually a form of borrowing—forced loans from workers and government—or subsidization.⁷⁶ The cash necessary for such a system to continue is generated by making export sales, sometimes at less than cost.⁷⁷ Russia's "virtual economy" is in fact a natural continuation of the Soviet socialist economy.⁷⁸ A form of barter—not familiar to those in the West who may engage in barter in order to evade income taxes—enables the virtual economy to endure.

Inefficient enterprises survive because they are able to have value redistributed to them from other sectors of the economy, notably the natural resources sector.⁷⁹ Arbitrary pricing that creates the illusion of value allowed the virtual economy to emerge in socialist times, and it allows the virtual economy to continue after the fall of the Soviet Union.⁸⁰ Gaddy and Ickes⁸¹ illustrate this by offering a simple model with four sectors: the household sector which supplies labor and receives benefits from the government; the government which taxes the other entities and transfers benefits to households; the resource-producing, value-adding sector; and the value-subtracting manufacturing sector.

A manufacturer may take 100 rubles worth of labor from the household sector and 100 rubles worth of resources from the resource sector to pro-

⁷⁴ See BRADY, *supra* note 23, at 29-30 (in March 1992, 90% of Russian industry bankrupt by Western standards); Andrew Higgins, *Twilight Economy: Lacking Money to Pay, Russian Firms Survive on Debt Barter System*, WALL ST. J., Aug. 27, 1998, at A1 (citing example of plant saved from bankruptcy by barter, debts, and favors).

⁷⁵ See Clifford G. Gaddy & Barry W. Ickes, *Russia's Virtual Economy*, 77 FOREIGN AFF., 53, 54 (Sept.-Oct. 1998).

⁷⁶ See BLASI, KROUMOVA & KRUSE, *supra* note 6, at 143 ("a kind of involuntary government subsidy"); Gaddy & Ickes, *supra* note 75, at 57.

⁷⁷ See Aron, *supra* note 13, (open and hidden welfare payments in Soviet times paid for by export sales of oil, natural gas, gold, and weapons, and by domestic sales of vodka).

⁷⁸ See Marshall I. Goldman, *The Cashless Society*, 97 CURRENT HIST. 319, 324 (1998).

⁷⁹ See Gaddy & Ickes, *supra* note 75, at 57; see Arnold, *supra* note 20 (natural resource producers carry the rest of the economy; raw materials producers employ 5% of Russians and produce almost 35% of GDP; "value-added" manufacturing employs 1/4 of the workforce and contributes 15% of GDP).

⁸⁰ See Gaddy & Ickes, *supra* note 75, at 57.

⁸¹ The process by which such inefficient enterprises survive is described in Gaddy & Ickes. *Id.* at 53.

duce an output worth 100 rubles. Thus the manufacturer has used 200 rubles worth of inputs to produce 100 rubles worth of output—a 100 ruble subtraction from value. But the manufacturer pretends that it has added value and charges 300 rubles for its output. Others accept the pretense because they will use the overpriced output in barter with one another or with the government. The manufacturer can give the resource producer 1/3 of its output and claim that it is worth 100 rubles. Both the manufacturer and the resource producer pay the government in kind—also with goods worth 1/3 of the actual tax bill in this model. Because it is not so feasible for the household sector to accept payments in kind, wage arrears and pension arrears have been a notorious feature of the post-Soviet economy.⁸² Overpricing for purposes of barter is by a multiple of two or three; for purposes of promissory notes, it is up to five.⁸³ And while the worker seemingly is quite short-changed in this system, he/she does retain a job, and that seems preferable to the prospect of unemployment. Other forces contribute to the persistence of barter as a key element of the Russian economy.

As a general matter, barter emerges as a preferred method of exchange whenever there is hyperinflation—as Russia has experienced—or when, for some other reason, money simply does not provide an accurate reflection of the value of some good or service—as occurred in the Soviet Union when citizens possessed ample sums of money but could not buy desired goods (or desired quality) because they were not available.⁸⁴ In such environments, goods—e.g., good, foreign-made television sets—hold their value much better than the currency and so can become a preferred way to hold wealth.⁸⁵ Barter increases as a share of GDP when an economy is dysfunctional.⁸⁶

Barter has always been a part of both the Russian and Soviet economies. Russia's pre-revolution economy was agrarian with a large portion of the population comprised of peasants who dealt with each other on a barter basis.⁸⁷ The end of World War I, the Bolshevik Revolution, and the civil war brought hyperinflation—which increased reliance on barter.⁸⁸ Central

⁸² See *id.* at 57-58.

⁸³ See *id.* at 62; cf. Andrew Higgins, *With Banks Ailing, Russians Gain Credit from Trees and Milk*, WALL ST. J., Aug. 18, 1999, at A8 (worker's salary docked for furniture items far more than cost of goods in stores).

⁸⁴ This reality is reinforced by the popular Russian adage "in the old days, there was lots of money and nothing to buy. Now there is lots to buy and no money."

⁸⁵ See *Virtual Reality: Barter Is the Rule in Russia – and That Has a Price*, BUS. CENT. EUR. (Nov.-Dec. 1998), available at <http://www.bcemag.com/y1998/dez98/Cover/9812cover.htm> ("Russians – rightly it turns out – have never had much faith in the ruble")

⁸⁶ See Goldman, *supra* note 78, at 319.

⁸⁷ See *id.*

⁸⁸ See *id.* at 319-20.

planning in the Soviet economy with its distortions and shortages perpetuated reliance on barter.⁸⁹

The inevitable failure of the central planners' omniscience resulted in a rigid economic plan that required barter in order to fulfill it.⁹⁰ This in turn created the need for *tolkatchi*,⁹¹ i.e., persons who could come up with whatever plant managers needed to fulfill their obligations under the plan. *Tolkatchi* usually accepted swaps for these needed goods.⁹² *Tolkatchi* possessed a skill in demand that was quite necessary to the survival of the planned economy even though their activities were ostensibly illegal.⁹³ This aspect of the centrally planned economy has not disappeared, and not surprisingly transactions can get quite complicated—involving several parties to obtain one item.⁹⁴ The expense of *tolkatchi* represented a direct transaction cost, in addition to the very high indirect cost of economic distortions, of the Soviet Union's centrally planned economy. A system of "spiral[ling]⁹⁵ debts and counterdebts"⁹⁶ is enormously inefficient.⁹⁷ Payments that are non-monetary constitute an enormous drag on an economy.⁹⁸ Inevitably, there is a costly misallocation of resources.⁹⁹ It literally is true

⁸⁹ See BRADY, *supra* note 23, at 21 ("the distortions and inadequacies of socialist central planning had turned Russia into a great trading society").

⁹⁰ See Goldman, *supra* note 78, at 319-20; see also BRADY, *supra* note 23, at 49-50 (barter necessary to overcome inefficiencies of centrally planned economy; "bureaucratic market").

⁹¹ The translations of the pertinent terms are interesting: толкать: push, give a push/shove; толкач: pusher, go-getter. See A.I. SMIRNITSKY (director), RUSSIAN-ENGLISH DICTIONARY 789 (6th ed. 1962).

⁹² See Goldman, *supra* note 78, at 319-20.

⁹³ See *id.*; see also BRADY, *supra* note 23, at 50 (Soviet trading system bred corruption).

⁹⁴ See Goldman, *supra* note 78, at 322 (citing example of purchase of jet plane in exchange for natural gas; natural gas bartered by jet manufacturer for cars, tractors, and buses – in turn swapped for jet engine).

⁹⁵ Because of hyperinflation in 1992 – i.e., a 26-fold increase in prices – and the government's response of rigid monetary controls designed to reduce business activity, businesses learned that inter-firm debt was a means of avoiding the controls. Inter-firm debt grew from 37 billion rubles in January 1992 to 3.2 trillion rubles in August 1992 to 25 trillion rubles in 1994. These figures are not adjusted to reflect the hyperinflation. In January 1998, unpaid wages and taxes and inter-firm obligations totaled 800 trillion rubles, or 24% of the gross domestic product. See *id.* at 322; see also BRADY, *supra* note 23, at 29.

⁹⁶ Higgins, *supra* note 74.

⁹⁷ See Goldman, *supra* note 78, at 319 (barter extremely inefficient; high transaction costs; buyers and sellers never sure what their actual costs and prices are); cf. Edmund L. Andrews, *Russia's Huge IOU Market Luring Investment Traders*, DALLAS MORNING NEWS, Oct. 19, 1997, at 41A (a trading chain of IOUs can go "across the country and back").

⁹⁸ See *Virtual Reality: Barter Is the Rule in Russia – and That Has a Price*, *supra* note 85 ("a World Bank survey of Russian managers ... found that non-cash transactions cost 20-25% more in terms of time and effort").

⁹⁹ See *id.*

that some plants must store the bulky items they receive in trade for their output.¹⁰⁰

It is difficult to know the extent of barter transactions in Russia—just as it is difficult to know the extent of barter transactions anywhere else. But: “An official survey of 210 enterprises at the backbone of the economy estimated that barter, debt-swaps and other non-monetary deals accounted for 73% of transactions in 1996 and 1997. The businesses surveyed paid only 8% of their taxes with real . . . money.”¹⁰¹

Instead of *tolkatchi*, Russian trading companies now act in post-Soviet times as intermediaries to make the economy work.¹⁰² The trading companies are profitable while fifty per cent of newly privatized enterprises in Russia run at a loss.¹⁰³ The trading companies are run by or in the interest of firms’ managers and can be the means by which such managers bilk their own firms. They are able to exploit price structures by buying at controlled, artificially low prices, and selling in a market where prices are higher and not controlled—a very profitable and relatively risk free form of arbitrage. The interlocking interests between trading companies and some companies present opportunities for self-dealing that many managers—not subject to shareholder control—cannot resist.¹⁰⁴

A slightly more sophisticated aspect of the barter economy is what is in essence a negotiable IOU, i.e., a *veksel*.¹⁰⁵ This is an IOU issued by Russian businesses who are short of cash. The Russian government itself uses *veksels* when it simply cannot pay cash that it owes.¹⁰⁶ When the government issues a *veksel* with a certain maturity date several months into the future, the recipient, through a bank or trader, will likely resell it at a considerable discount; the purchaser can later satisfy a tax obligation of the face amount of the *veksel*.¹⁰⁷ This is hardly efficient, yet *veksels* issued by the Russian government and private businesses account for 23% of the country’s “cash” transactions.¹⁰⁸ The discount on *veksels* is considerable—reflecting the real value of the good whose value is artificially established

¹⁰⁰ See Higgins, *supra* note 74 (citing example of plant that manufactures machine parts having to store payments of wool, blankets, tablecloths, and flax).

¹⁰¹ *Id.*; see also Goldman, *supra* note 78, at 319 (barter occurs in 70% to 80% of the country’s business transactions); *Russia’s Economic Quagmire*, *ECONOMIST*, Apr. 24, 1999, at 69, 70 (noting expert’s sense that “virtual” economy had increased from 50% of Russian economy before August 1998 to 70% in April 1999).

¹⁰² See Goldman, *supra* note 78, at 319, 322-23.

¹⁰³ See *id.* at 319, 323.

¹⁰⁴ See *id.* (citing example of the Magnitigorsk steel mill paying six times the prevailing market price for scrap steel; trading company from whom mill made purchase run by brother of steel mill’s general director).

¹⁰⁵ See *id.* (indicating that *veksels* date from prerevolutionary times).

¹⁰⁶ See *id.* at 323-24 (1998).

¹⁰⁷ See *id.* at 324 (illustrating such use of a *veksel*).

¹⁰⁸ See *id.*

reflecting the real value of the good whose value is artificially established as the face amount of the *veksel*.

When customary measures are applied to the virtual economy, i.e., barter economy, the data appear much better than they really are. It appears that all of the private sectors are profitable.¹⁰⁹ "The virtual economy masks the non-viability of the value-subtracting manufacturer."¹¹⁰ Increases in productivity are not necessarily good news when those increases are made by value subtracting manufacturers—even though economic statistics may appear to be improving.¹¹¹ Abolishing the virtual economy would increase (substantially) the tax burden of productive sectors of the economy, force manufacturers into bankruptcy, cost workers their jobs, and reduce pensions.¹¹² Hence the very sectors involved in the virtual economy want to keep it.¹¹³ Paradoxically, some of the reforms that many experts acknowledge to be necessary might actually help the virtual economy to survive. Tax evasion, corruption, and theft would injure any economy, and the virtual economy is no exception. Reduction or elimination of tax evasion, corruption, and theft would actually help Russia's virtual economy to survive.¹¹⁴

Accounting according to Soviet standards facilitates the charade that Russia's virtual economy is real. The same data regarding a firm yield vastly different conclusions if Russian accounting standards rather than western accounting standards are applied.¹¹⁵ Soviet accounting standards—from which Russian accounting standards are derived—were not designed to track profit.¹¹⁶ Rather:

The purpose of accounts is to help the state—formerly the central planners and now the tax police—stop people from stealing by keeping tabs on inventories—not to help managers develop their businesses.

¹⁰⁹ See Gaddy & Ickes, *supra* note 75, at 59.

¹¹⁰ *Id.* at 59-60; see also BRADY, *supra* note 23, at 36 (state enterprise managers fighting for their jobs, privileges, and lifestyles staved off bankruptcies and layoffs).

¹¹¹ See Gaddy & Ickes, *supra* note 75, at 62.

¹¹² See *id.* at 60.

¹¹³ See *id.*

¹¹⁴ See Clifford G. Gaddy and Barry Ickes, *This Bailout Will Set the Stage for the Next Crisis*, LOS ANGELES TIMES, July 17, 1998, part B at 9 (opinion piece) (eliminating corruption and tax evasion could have the effect of reducing leakage from the virtual economy).

¹¹⁵ See Andrew Higgins, *Go Figure: At Russian Companies, Hard Numbers Often Are Hard to Come By*, WALL ST. J., Aug. 20, 1998, at A1. The article offers the example of the Bratsk Aluminum Plant which had a \$37 million profit when applying Russian accounting standards and a \$7.4 million loss when applying western accounting standards; see also Goldman, *supra* note 78, at 319 (describing Uralmash, a producer of machine tools and armaments; profits by Russian accounting methods of \$40 million, but losses by western accounting methods of \$50 million).

¹¹⁶ See Puffer & McCarthy, *supra* note 28, at 1295-86 (during communist period, "accounting practices were centrally-controlled with the audit function being more of a government inspection than an independent financial audit in the Western sense").

Soviet accountants served as the state's quartermasters. In a system driven by production rather than profit, they tracked the flow of inputs and outputs, heedless of whether value had been added or subtracted, money made or lost.¹¹⁷

The unreality of such accounting is of course magnified if the figures that track inventory are themselves doctored.¹¹⁸ Even concepts such as depreciation are applied in such a way that virtual profits are increased. Depreciation schedules do not reflect the real wear-and-tear of a productive asset nor its useful life. Instead, state-set depreciation schedules prescribe much longer periods thereby reducing the amount by which depreciation reduces profit.¹¹⁹ *The Economist* noted that "[t]he absence of true price-information means that nobody can say which firms are adding value and which are destroying it, including the firms themselves. Rational credit and investment decisions are impossible, and would remain so even if anybody were to start wanting to make them."¹²⁰

There are still other "advantages" to a barter economy. Cash is vulnerable to seizure by tax authorities and organized crime.¹²¹ Holding money in banks does not help, as organized crime often owns banks simply to learn who is able to make substantial deposits.¹²² When cash is necessary, it is raised by selling some of the manufacturer's output in world markets at less than the cost of production.¹²³ Households may also be capable of raising cash by selling whatever they can.¹²⁴

The effect of a virtual economy on the public sector is particularly devastating. When taxes are collected in the form of money, they can be allocated according to priorities with considerable flexibility. But when taxes are collected in kind, priorities must be shaped by the identity of the particular resources to which the government has access. Rarely, if ever, would the priorities established in such a system be the same as they would be where the government is able to collect taxes in the form of money.¹²⁵

¹¹⁷ See Higgins, *supra* note 115, at A1.

¹¹⁸ See *id.* (noting that former chief of the State Statistics Committee had been arrested for skewing numbers in order to help companies avoid taxes).

¹¹⁹ See *id.* (noting that Russian standards require depreciating a building over 100 years rather than a more realistic length of time, e.g., 30 years).

¹²⁰ *The Cash Don't Work*, *supra* note 39, at 100.

¹²¹ See Gaddy & Ickes, *supra* note 75, at 60; see also Goldman, *supra* note 78, at 321 (noting that the more public the operation of a new business in Russia, the more vulnerable it becomes to crime and extortion; also noting that barter is a tool for evasion of taxes).

¹²² See Goldman, *supra* note 78, at 321.

¹²³ See Gaddy & Ickes, *supra* note 75, at 61.

¹²⁴ See *id.*

¹²⁵ See *id.* at 62-63; see also Higgins, *supra* note 74 (citing example of a textile factory that obtained electricity by giving 400 wool blankets to a camp for handicapped children – the value of the blankets being deducted from the electric company's tax bill).

The virtual economy has provided stability for people who are highly risk averse. Despite the fact that western media often relate that one group or another has not been paid its wages in many months or years, the virtual economy provides a social safety net. Workers do keep their jobs,¹²⁶ although their real wages are quite low and certainly less than they would be if such workers worked in an efficient and profitable plant.¹²⁷ "Wages go unpaid most often in those industrial sectors where wages are already low."¹²⁸

Retaining jobs is particularly important in cities where there are only one or two factories.¹²⁹ The squeeze experienced by workers in such places who cannot move is especially severe. In the event one group, e.g., coal miners, makes enough noise, government must play the role of referee in deciding which of many deserving groups receives wages that are due.¹³⁰ Government also plays the role of assuring that activities that could efficiently and profitably export their output, e.g. resource production, continue to fulfill the needs of Russia's inefficient firms. For example, oil companies should not be allowed to export too much of their product—only enough to generate the cash to keep the virtual economy going.¹³¹ Russia imposes a substantial tariff on its own oil exports.¹³²

The reforms necessary to move Russia's virtual economy to a market economy are more than simply trying to assure that less value is lost in the *existing* system, e.g., by firing managers of state-owned enterprises that do not pay wages. Rather the reforms must strike at the heart of the system itself, e.g., by enforcing bankruptcy laws so that inefficient enterprises are put out of business and sold off, perhaps asset by asset.¹³³ "[D]etermined application of bankruptcy laws" would be the most effective action that could be taken to move the economy away from barter.¹³⁴

This would induce a substantial number of factory directors to settle their bills and pay in cash. Many businesses, including a large number that are officially operating at a loss, would find the means to pay their bills if there were an ef-

¹²⁶ See BLASI, KROUMOVA & KRUSE, *supra* note 6, at 111-12 (unemployment in 1995 only 8% despite fact that production had dropped by half since 1991); Patrice Hill, *Making Do in a "Pretend" Economy: Black Market Is Crucial for Russians to Survive*, WASHINGTON TIMES, Mar. 22, 1999, at A1 ("Russians hang onto [the pretend economy] because it enables them to keep jobs in noncompetitive industries that could not survive outside Russia").

¹²⁷ See Gaddy & Ickes, *supra* note 75, at 63.

¹²⁸ See BLASI, KROUMOVA & KRUSE, *supra* note 6, at 111.

¹²⁹ See BRADY, *supra* note 23, at 32 ("In many town in the Urals, Siberia, and the Far North, only one or two plants employed and supported entire communities. That's why the prospect of layoffs and unemployment was truly dangerous").

¹³⁰ See Gaddy & Ickes, *supra* note 75, at 63.

¹³¹ See *id.* at 63-64.

¹³² @ 20/ton.

¹³³ See Gaddy & Ickes, *supra* note 75, at 64-65.

¹³⁴ See Goldman, *supra* note 78, at 324.

fective threat to close down the business, return it to the state, and throw out the existing management. But there is a political obstacle: throwing not only the managers but the workers out into the streets could spark civil upheaval. This is what makes the prospect of meaningful and fundamental reform so doubtful.¹³⁵

The prospect of bankruptcy would no doubt prompt *some* firms to restructure and become efficient.

IV. A GLIMPSE AT THE STATE OF THE RUSSIAN ECONOMY: THE McKinsey Report

In October 1999, the McKinsey Global Institute published the report UNLOCKING ECONOMIC GROWTH IN RUSSIA.¹³⁶ In the report, the Institute describes the structure and efficiency of ten different industries: steel, cement, oil, dairy, confectionery, residential construction, food retailing, general merchandise retailing, hotels, and software. The overall efficiency level of these industries combined is 19% of the United States levels of efficiency.¹³⁷

The concern of this paper is with how certain critical laws *affect* efficiency—not with the precise level of efficiency. As such, the paper here notes the *structural* patterns that the Institute observed in the various industries with a view towards commenting on the likely effectiveness of the Russian bankruptcy law on the inefficiencies wrought by the structure of industries. Without question, much of the structure of Russian industries is the remnant of central planning. No doubt the planning itself appeared efficient and wise at the time; the disastrous distortions that persist are themselves compelling testimony to the total folly of central planning in building an economy that generates wealth for citizens.¹³⁸

A. Company Towns

Soviet planners evidently concluded that an efficient method of producing large quantities of some items that seemingly require large plants in order to achieve efficiencies of scale was to create company towns. This

¹³⁵ See *id.*

¹³⁶ The report is available from the McKinsey Global Institute's home page on the world wide web: <www.mckinsey.com>. There have been other reports issued by respected organizations whose conclusions are similar. See Reuters, *Basic Reforms Needed for Growth Says OECD*, MOSCOW TIMES, Mar. 9, 2000, available at LEXIS News Library, Mostms File (Organization for Economic Cooperation and Development). The McKinsey Global Institute's report is one that is readily available for free. The report includes an Executive Summary and separate reports for each of the ten industries noted. Hereinafter, reference is made to MCKINSEY and to the particular industry report or Executive Summary.

¹³⁷ See MCKINSEY, *Executive Summary*.

¹³⁸ See Arnold, *supra* note 20 (humorous analogy applicable to Russian corporate reform are directions to a (female?) traveler asking for directions: "Well, I wouldn't start from here").

was the pattern in steel¹³⁹ and oil.¹⁴⁰ As is the case in any country, dislocations caused by plant closures are particularly acute in company towns. Russian laws tie social benefits to a worker's current residence, so labor is much less mobile in Russia than it is in other countries.¹⁴¹ This point intensifies the worst aspects of company towns. The reduction of the workforce in a steel town would invite social unrest; moreover, a plant's labor force is essentially held captive to the whim of monopolistic management who can simply decide not to pay the wages of labor, at least not until inflation has eroded the wage's purchasing power.¹⁴²

B. Obsession With Job Preservation

Russians are incredibly risk averse in matters of employment. To be sure, some of this is caused by laws that restrict mobility and the large gaps in any safety net. Workers regard local governments as responsible for assuring continued employment, no matter how thinly the wage pie is sliced. Nothing could be worse at a time when significant reductions in the labor forces of various industries would not reduce production *at all*.¹⁴³ Local governments are responsive to this obsession, because widespread unemployment would cause social unrest in their communities.¹⁴⁴ Local governments may even retaliate against companies that do lay some employees off.¹⁴⁵ This response helps to perpetuate the industry structures that are so inefficient.

C. Barter

The prevalence of barter in the Russian economy has already been noted. Further comment is in order to understand fully the intensity of the forces that drive Russia to its virtual barter economy. In the industries noted above, only one branch of the software industry ("project services") comes close to western levels of efficiency.¹⁴⁶ Productivity is so low in most Russian industries that a great number of companies should be forced to quit business. This of course would cause massive layoffs of employees. Barter allows unproductive companies to survive. They can do business

¹³⁹ See MCKINSEY, *Steel* 2.

¹⁴⁰ See *id.*, *Oil* 9-10.

¹⁴¹ Cf. *id.*, *Confectionary* 8 (lack of mobility increases local governments' incentive to prevent layoffs).

¹⁴² See *id.*, *Steel* 11.

¹⁴³ See *id.*, *Steel* 5; *Cement* 4; *Oil* 7; *Dairy* 6; *Confectionery* 6-7; *Residential Construction* 6; *Hotels* 5.

¹⁴⁴ See *id.*, *Steel* 11; *Cement* 7.

¹⁴⁵ See *id.*, *Oil* 10.

¹⁴⁶ See *id.*, *Software* 1 (72% as productive as United States project services industry).

with bankrupt customers.¹⁴⁷ They can avoid taxes because barter creates little or no cash that a tax collector could seize.¹⁴⁸

Thus local governments subsidize the companies that generally are the *most* inefficient and where massive layoffs would otherwise be appropriate from an efficiency standpoint.¹⁴⁹ A local government that itself may lack money subsidizes inefficient operations through tax arrears¹⁵⁰ and cheap energy.¹⁵¹ The local government often allocates contracts to, or directs others to allocate contracts to,¹⁵² the inefficient producers.¹⁵³

Even these government-provided benefits or subsidies probably are not sufficient to assure the survival of some inefficient businesses with far too many workers. Many local governments affirmatively discriminate against the more efficient companies¹⁵⁴ by making them pay higher taxes,¹⁵⁵ pay more for energy, pay higher tariffs,¹⁵⁶ endure more harassment and red tape,¹⁵⁷ and do business from less desirable locations.¹⁵⁸ Local governments may also preclude efficient producers from implementing layoffs.¹⁵⁹ Such affirmative discrimination can result from discriminatory enforcement of legal rules, e.g., condoning tax evasion by one group of firms but not by others.

The more efficient producers struggle to survive and are unable to buy out¹⁶⁰ or drive the inefficient producers out of business.¹⁶¹ Efficiency is irrelevant. Instead it is connections that count. The well-connected, and often the most corrupt, receive the government contracts.¹⁶² Managers lose

¹⁴⁷ See *id.*, *Steel 14; Oil 8*.

¹⁴⁸ See *id.*, *Steel 14; Cement 6*.

¹⁴⁹ Cf. Feifer, *supra* note 12 (describing City of Moscow's substantial investments in Moskvich and ZiL).

¹⁵⁰ See MCKINSEY, *Steel 10; Cement 7; Dairy 7; Confectionery 8*; see also Gregory Feifer, *City Investments Range Beyond Mere Carmakers*, MOSCOW TIMES (May 16, 2000), available in LEXIS, News Library, Mostms File (describing tax arrears owed to City of Moscow as means of spending money on enterprises).

¹⁵¹ See MCKINSEY, *Steel 10; Cement 7*.

¹⁵² See *id.*, *Steel 10; Residential Construction 13, 14*.

¹⁵³ See *id.*, *Cement 7, Residential Construction 14*.

¹⁵⁴ See *id.*, *Cement 7; Residential Construction 15* (discriminatory "community gains" payments); *Food Retailing 4, 6* (failure to enforce laws against smuggling and against sales of counterfeit goods).

¹⁵⁵ See *id.*, *Food Retailing 4, 6; General Merchandise Retailing 5-6*.

¹⁵⁶ See *id.*, *Food Retailing 4; General Merchandise Retailing 5-6*.

¹⁵⁷ See *id.*, *Oil 8, 9; Food Retailing 7* (excessive inspections, etc.); *General Merchandise Retailing 6*.

¹⁵⁸ See *id.*, *Food Retailing 1* (Executive Summary); *General Merchandise Retailing 1* (Executive Summary).

¹⁵⁹ See *id.*, *Dairy 7; Confectionery 7*.

¹⁶⁰ See *id.*, *Cement 7*.

¹⁶¹ See *id.*, *Dairy 7; Confectionery 9*.

¹⁶² See *id.*, *Residential Construction 14*.

the incentive to improve efficiency because local governments shield the losers and obstruct the potential winners.¹⁶³

D. Distortions Caused By Central Planning That Persist

Central planning caused some enormous distortions whose effects persist. Russian companies persist in inefficiently producing products for which there is already a national or even world-wide oversupply.¹⁶⁴ The persistence results from some of the factors already noted, i.e., the obsession with job preservation in company towns with the consequent efforts to keep all companies afloat through barter, contract allocation, etc. The obsession with job preservation causes the Russian economy implicitly to defy the law of comparative advantage. Russian steel has been the subject of dumping claims in several countries.

E. Perverse Incentives

Naturally when efficiency is not rewarded but some other *modus operandi* is rewarded, there is no incentive to strive for the type of efficiency that would benefit consumers. In Russia the reward system in place for those in a position to engage in extensive restructuring or to take a firm into bankruptcy is perverse. Managers of inefficient firms often benefit from barter activities and cozy relationships with local governments. They may themselves own or profit from trading companies who purchase products at artificially low prices thereby siphoning off whatever profits their companies generate¹⁶⁵—at the expense of minority shareholders/workers (who remain employed), suppliers, and government.

V. AN "EMERGING ECONOMY"

Russia's is not a developed economy but an emerging economy. Its GDP is less than that of Taiwan, South Korea, or India; its GDP per head is equal to that of Colombia.¹⁶⁶ An economy driven mostly by barter is an economy based upon relationships, not on contract or a rule of law.¹⁶⁷

¹⁶³ See *id.*, Dairy 12.

¹⁶⁴ See *id.*, Steel 4; Cement 6.

¹⁶⁵ See *id.*, Steel 12; Cement 8, Residential Construction 15; David Satter, *Russia: Its Place in the Twenty-First Century and the Implications for the United States*, 8 DEMOKRATIZATSIYA 439 (2000) (animating factor in Russian economy theft, not productivity).

¹⁶⁶ See THE ECONOMIST, THE WORLD IN 1999, at 74, 75, 76, 77.

¹⁶⁷ BRADY, *supra* note 23, at 187 (footnote omitted):

Richard Dean, a partner at Coudert Brothers and one of the most experienced American lawyers in dealings with Russia, put it this way: "Russia remains a long way from a 'rule of law' state; it remains a 'rule of relationships' state much like many developing countries.

[A]n emerging economy is a polity in which commercial institutions are changing from a relational orientation to a formal orientation. A formal orientation allows business and businesspersons in emerging economies to enter into commercial relations with persons and entities outside of that polity.¹⁶⁸

The paper has already noted that such an economy is very inefficient.¹⁶⁹

A relation-based economy is a matter of culture. Culture is not easily changed—and probably not willingly.¹⁷⁰ The relationships that drive the Russian economy exist not only “horizontally,” e.g., between traders, but also “vertically,” e.g., between government and governed. The power in a governmental vertical relationship does not necessarily reside in the government. If the power in a vertical relationship resides outside of the government, the one with power is in a position to call upon government for special favors unavailable to competitors. Unfortunately, this has occurred in Russia.¹⁷¹ The consequence has been further economic distortion, with rewards going not to the efficient but to the well-connected. The well-connected receive contracts, subsidies, credits, loans, etc. This enables them to compete with efficient enterprises on a basis other than their own efficiency. This is hardly an environment conducive to private investment.

VI. NEAR TERM GOALS OF LEGAL REFORM

After the fall of socialism, the Russian economy went into a downward spiral of barter that itself preserved many of the perverse incentives of the old system, i.e., to build power and wealth through relationships rather than through efficiency. At the same time and to varying degrees, foreign aid money came into Russia. This money did not appreciably ameliorate Russia's problems, certainly not the problems identified here. The problems identified here are at least in part cultural, and it is not possible to buy off a culture.

¹⁶⁸ Philip M. Nichols, *A Legal Theory of Emerging Economies*, 39 VA. J. INT'L L. 229, 232 (1999).

¹⁶⁹ The prices of two goods expressed in a currency, e.g., dollars, represent the marginal rate of substitution available to every consumer between those two goods. “[P]rice works like a mechanism to allocate goods in such a way that consumers cannot make themselves better off swapping goods with each other.” SEIDENFELD, *supra* note 4, at 9-10.

¹⁷⁰ See Nichols, *supra* note 168, at 232 (“[C]hange in these economies is likely to be slow because relational institutions are difficult to change”).

¹⁷¹ See Virginie Coulloudon, *Vladimir Putin's Vertical State and the Embryo of a Horizontal Opposition*, 8 DEMOKRATIZATSIYA 421, 422 (2000) (ultimate goal of “FIGs” to establish for themselves patron-client relationship with Kremlin or regional governors); Melissa Akin, *Stalled Transition*, MOSCOW TIMES, Nov. 16, 1999, available at LEXIS, News Library, Mostms File (interests of “oligarchs” to manipulate government policy to benefit their businesses to the detriment of the business climate).

Nevertheless, there is now an evolution of the Russian business culture,¹⁷² and there is no turning back; but evolution is a slow process. Russia's economy, so long reliant on relations, will not necessarily respond in desired ways to massive infusions of money. Aid to Russia is counter-productive if it helps to prop up the virtual economy.¹⁷³

[A failing of prior aid efforts] lay in thinking that lasting institutions can be built by supporting particular people, instead of helping to facilitate processes and the rule of law. A system based primarily on personal connections and handshakes did not foster the development of independent institutions that could outlive their current executives.¹⁷⁴

While it is natural to want to assist those who want reform and to deny assistance to those who oppose it, the final *objective*, irrespective of the *means*, must be apolitical.¹⁷⁵

The West must be realistic about *its* role in Russia's transition to a market economy. It cannot lead the transition. Rather it can only hope to help Russians to lead it.¹⁷⁶ The effort to lead reform rather than have Russians lead it enhances the credibility of anti-reform elements, notably the communists, who are able to trumpet the absence of real benefits to Russians except for a select few.¹⁷⁷ Reform is a slow process that occurs on many fronts; it can not be instantaneous. The cultural aspects of reform will take a long time to materialize. Aid packages from the West will not "[exorcise] the legacies of communism itself."¹⁷⁸

¹⁷² Russia has "opened itself to Western ideas and influences to an astonishing degree." Gumbel and Robbins, *supra* note 21.

¹⁷³ There are tempting reasons to provide such aid: it provides stability, keeps the ruble from depreciating, and prevents dislocations caused by many bankruptcies. See Gaddy & Ickes, *supra* note 75, at 65-67.

¹⁷⁴ See WEDEL, *supra* note 40, at 162.

¹⁷⁵ See *id.* at 163 (1998):

To foster reform, donors need to work to develop a market infrastructure that all relevant parties can support – not just one political faction. As one aid-paid consultant expressed it: "One of the hardest parts of Western aid ... was figuring out how to build member-owned, member-driven organizations that are neutral third parties and don't have a vested interest in the success of one or several parties. ... The hardest thing to get people over is political ties ... to get leaders of organizations to seek opinion and perform for people who aren't political buddies."

¹⁷⁶ The lesson: Russia is changing and becoming more familiar to Western eyes, but in its own way, at its own pace. "One should avoid the hubris that foreigners can make much of a difference anywhere," says Charles Blitzer, who until recently worked as the World Bank's chief economist in Moscow. "All foreigners can do is support and help that process. They can't direct or lead it."

Gumbel and Robbins, *supra* note 21.

¹⁷⁷ See WEDEL, *supra* note 40, at 162 ("by promoting the ... Chubais clan, and excluding other, less Westernized groups shaping Russian politics and economics, the U.S. aid establishment offended many Russians and fueled anti-Western sentiment").

¹⁷⁸ See *id.* at 21 (distinguishing objectives of aid to Eastern Europe from aid given previously to Third World countries).

This paper examines possible legal reforms that can *assist* in enhancing the role of contract rather than relationships in the Russian economy. To be a force for good, reformed laws must be enforced. The focus here is on those laws that would have the greatest impact in arresting the vicious downward spiral¹⁷⁹ of the virtual economy. Hence, the focus will not be on those laws whose lack of enforcement may receive the greatest publicity, e.g., criminal laws. Rather the focus is on those laws that would most effectively address the very foundation of the virtual economy, i.e., the bankruptcy laws and the "laws" pertaining to government interference and subsidization of inefficient firms. And of course any argument for law reform is essentially addressed to Russians more than to anyone else.

Russian leaders should look for ways to encourage private investment by identifying the ways in which they currently discourage it.¹⁸⁰ One way to discourage investment is to reward inefficient and non-viable firms at the expense of efficient firms. Local governments have proved to be very adept at implementing this type of perverse reward system. Instead of rewarding the inefficient and non-viable, law in Russia should be a tool by which such firms are removed from the competitive landscape. That occurs through enforcement of effective bankruptcy laws.

A. Bankruptcy and Restructuring

A capitalist market rewards only the most efficient suppliers. The inefficient must exit a market and utilize resources in some other endeavor. In this way, a nation realizes the greatest possible wealth, i.e., value.¹⁸¹ When the inefficient (and unprofitable) do not exit, the system must force them to do so. A legal system forces the inefficient to exit through bankruptcy. It is said that "capitalism without bankruptcy is like Catholicism without sin."¹⁸²

In Russia, at least two broad questions concerning bankruptcy arise. The first is whether there are conditions that inhibit the working of *any* bankruptcy law, no matter how well designed. Political policies may so favor the continued existence of insolvent enterprises that the best bankruptcy laws in the world cannot foster efficiency. The second is whether the bankruptcy law is itself efficient in either forcing inefficient enterprises out of business or restructuring them so that they become efficient. The paper now addresses these two questions in turn.

¹⁷⁹ See *Virtual Reality: Barter Is the Rule in Russia – and That Has a Price*, *supra* note 85 ("Few circles could be more vicious").

¹⁸⁰ Cf. Igor Semenenko, *De Beers Abandons Diamond Project*, MOSCOW TIMES, May 17, 2000, available at LEXIS, News Library, Mostms File (noting that legal and tax regimes in need of reform).

¹⁸¹ Value is measured by willingness to pay or by willingness to sell.

¹⁸² BARRY EICHENGREEN, TOWARD A NEW INTERNATIONAL FINANCIAL ARCHITECTURE PRACTICAL POST-ASIA AGENDA 15 (1999) ("it is said;" evidently Professor Eichengreen makes no claim of authorship).

1. Inhibiting Bankruptcy and Restructuring

As this paper has noted, the Russian enterprises that emerged in privatization were notoriously inefficient.¹⁸³ Unfortunately, the political climate has frequently seriously undermined the good that a bankruptcy law could accomplish.

First, the political system has done little or nothing to remove the persons inept at operating in a market economy, but who were nevertheless given charge of enterprises. During privatization, these managers gained economic power without responsibility to shareholders, to their enterprise, or to the national economy. As one observer noted, such persons acquired their ownership and managerial status through "insolence, moral compromise, abuse of . . . position within the country's power structures, and crime."¹⁸⁴ Such talents are not particularly useful to operating in a market economy.

Second, the Russian government has too often made available favors, e.g., credits, that it dispensed on the basis of political connections. This of course rewards the very managers whose obsolete skills should not be equated with business acumen. It always was an article of faith that privatized firms would need to be restructured, e.g., employee cutbacks, changes in product lines, financial realignment—perhaps in joint ventures or with foreign investment, and that there should be reductions in social spending on employees.¹⁸⁵ Even the best firms were not well-run.¹⁸⁶ Privatized firms must be de-politicized so that they can redirect their efforts from seeking favors from politicians to marketing and sales.¹⁸⁷ Unfortunately, the fact that holdover managers had developed the skills in the Soviet socialist economy of getting subsidies and acquiring supplies—not in marketing and sales—does not convince them that they should cede power to those with more relevant skills.¹⁸⁸

Inept and unaccountable management of course discourages outside investment, and managers and workers cannot provide any investment capital. Without a wholesale purge of such management—and perhaps their firms too—the downward spiral of the virtual economy cannot be broken. The twin objectives of bankruptcy in Russia should be the closing of hopelessly inefficient firms and the pressuring of others to restructure in more than a cosmetic way so as to become efficient and competitive on a

¹⁸³ See BLASI, KROUMOVA & KRUSE, *supra* note 6, at 178 (in 1996, 3/4 of all Russian firms in need of "radical and far-reaching restructuring").

¹⁸⁴ Puffer & McCarthy, *supra* note 28, at 1287-88 (quoting Konstantin Zuyev, *MOSCOW TIMES*, July 23, 1995).

¹⁸⁵ See BOYCKO, SHLEIFER & VISHNY, *supra* note 10, at 125.

¹⁸⁶ See BRADY, *supra* note 23, at 141 ("Red Directors" enterprises were not working well).

¹⁸⁷ See BOYCKO, SHLEIFER & VISHNY, *supra* note 10, at 126.

¹⁸⁸ See *id.* at 129.

global scale. Real restructuring is *not* "negative restructuring,"¹⁸⁹ i.e., a firm's coping with reduced demand for its output by cutting its workforce by less than the reduction in output so that cost per unit actually increases.¹⁹⁰ Such "negative restructuring" does not eliminate managerial reliance on government subsidies.¹⁹¹ Governments must impose hard budget constraints so that managers have a real incentive to engage in real restructuring.¹⁹²

Radical [i.e., real] restructuring involves serious changes in four areas: management and control, organization of the business, capital, and the social services the enterprise provides for employees . . . [M]anagement leadership and modernization through capital investment are the critical ingredients.¹⁹³

"Current Russian managers may not have the heart for such far-reaching changes."¹⁹⁴

Bankruptcy *should* be the point at which the turn towards a rule-based market economy is identifiable. This is because bankruptcy is the point at which the inefficient are removed so that, given enough time, only acceptably efficient firms¹⁹⁵ remain.

Bankruptcy provides an interesting prism through which the development of an economy in transition can be gauged. First, it provides a test of fidelity to free-market economics. If the nation has moved from central planning to a free market system, it must be prepared to let businesses that are losing propositions fail rather than subsidize them in perpetuity. Second, it provides an interesting test of the treatment of foreign investment, since bankruptcy creates an acid test in which the claims of financial institutions, which predictably are more likely to be secured in some fashion, will be weighed against the claims of politically powerful groups, such as the work force, governmental entities and local trade debt. By and large, CIS nations have been quick to address the need for bankruptcy legislation—they have deliberated it in the context of new civil codes and have passed several special laws. This legislation has, broadly speaking, been pleasing to the foreign institutional patrons of the newly

¹⁸⁹ See BLASI, KROUMOVA & KRUSE, *supra* note 6, at 132.

¹⁹⁰ See Aron, *supra* note 22 (managerial response to reduced state orders not real restructuring, but lowered production, sale of inventory, profligate and reckless borrowing, withholding taxes, accrual of enormous inter-enterprise debts).

¹⁹¹ See BLASI, KROUMOVA & KRUSE, *supra* note 6, at 123.

¹⁹² See *id.* at 128.

¹⁹³ See *id.* at 125 ("The restructuring of a corporation that was formerly controlled by a ministry in Moscow involves more than cosmetic changes or general plans."); see also Atiyas, *supra* note 57, at 195 (necessary actions include "strengthening production, eliminating non-viable units, introducing proper managerial practices, adopting new technologies, liquidating unproductive assets, and eliminating excess staffing").

¹⁹⁴ See BLASI, KROUMOVA & KRUSE, *supra* note 6, at 125.

¹⁹⁵ This is not to say that *all* efficient firms will survive. But the damage done to the Russian economy by inefficient firms is so great that sweeping some efficient firms into the purge of inefficient firms is worth the cost.

emerging democracies. But the legislation has been remarkably underutilized.¹⁹⁶

The paper now turns to an examination of Russia's recently enacted bankruptcy law. Russia's willingness to invoke the new law demonstrates the intensity of Russia's desire to move to a market economy.

2. Russia's New Law on Insolvency

Russia has a relatively new bankruptcy law, promulgated on January 8, 1998. This paper examines some of the features of the statute as they relate to addressing the problems identified and offers comments.

Federal Law and Applicability: Russian bankruptcy law is federal law.¹⁹⁷ This of course has the advantage of making the applicability of the bankruptcy law uniform. The new law's unitary procedure improves on prior law which had several disparate bankruptcy procedures.¹⁹⁸ The bankruptcy law has broad application, i.e., to all commercial organizations except for: public enterprises, non-commercial enterprises operating in the form of a consumer cooperative, charitable foundations, or charitable funds.¹⁹⁹ The law also applies to credit organizations²⁰⁰ and individual citizens.²⁰¹ Foreign persons may participate in bankruptcy proceedings as creditors.²⁰² This should facilitate foreign direct investment—at least the absence of such a right of participation will not inhibit foreign investment.

Fact of Insolvency: Insolvency is defined as a debtor's inability to satisfy creditors' claims fully with respect to monetary obligations or to perform an obligation to make compulsory payments, i.e., taxes, dues, and other mandatory contributions.²⁰³ The law references "monetary" obligations. The manner in which the barter economy functions should hasten the bankruptcy of those non-viable entities that do business extensively by barter. The high valuations placed on items exchanged through barter is of course unrealistic, but it has the effect of increasing the monetary obligations of debtors. Hopefully the political interference necessary to save such enterprises will not be forthcoming.

¹⁹⁶ See Dmitry Pentsov, Glen Kolleeny & Scott Horton, *Bankruptcy Kazak Style: The Karmet Case*, RUSS. AND COMMONWEALTH BUS. L. REP., May 20, 1996, available at LEXIS, News Library, RCBLR File.

¹⁹⁷ See Federal Law # 6-FZ of January 8, 1998 on Insolvency, Art. 1(1). An English translation of the law by Garant-Service is available at LEXIS, Intlaw Library, Rflaw file.

¹⁹⁸ See *New RF Bankruptcy Law Workable but Flawed*, RUSS. AND COMMONWEALTH BUS. L. REP., Feb. 11, 1998, available at LEXIS, News Library, RCBLR File.

¹⁹⁹ See Federal Law # 6-FZ of January 8, 1998 on Insolvency, *supra* note 197, Art. 1(2).

²⁰⁰ See *id.* Art. 1(3).

²⁰¹ See *id.* Art. 1(4).

²⁰² See *id.* Art. 1(6).

²⁰³ See *id.* Art. 2.

Three months arrears at a time when the sum of a *citizen* debtor's obligations exceed the value of his/her property indicates an inability to satisfy creditors' claims with respect to monetary obligations or compulsory payments.²⁰⁴ Three months arrears in a *legal entity's* "monetary obligations" or obligation to make compulsory payments indicates an inability to satisfy creditors' claims.²⁰⁵ In the case of a legal entity, it is not necessary that the value of obligations exceed the value of a debtor's assets—only that the debtor not be meeting financial obligations as they come due. This precludes legal entities rich in relatively non-liquid assets—at least as perceived by a judge whose impartiality may not necessarily be taken for granted—who are unable to make payments to creditors to avoid bankruptcy.²⁰⁶ This is a definite improvement over the prior law that required an analysis of the debtor's balance sheet,²⁰⁷ a process that could be both lengthy and complicated.²⁰⁸

Not counted in a determination of insolvency are "monetary obligations" to make payments to citizens for harm to life or health and obligations to pay copyright royalties as well as fines or penalties incurred for non-performance or improper performance of a monetary obligation.²⁰⁹ A *legal entity* may not count in its determination of insolvency obligations to the debtor's founders.²¹⁰ These obligations do not disappear of course, but debtors who owe such liabilities whose cash flow is not adequate to pay such obligations avoid bankruptcy so long as they pay their other creditors. The effect of this definition may be perverse. It impedes the bankruptcy of those who have injured others, those who violate copyrights (e.g., pirates), and corporate founders to whom the corporation owes money (and of course the source of the obligation may be "obscure"). Such entities should be put out of business, a consequence that is made more certain through bankruptcy. Such claims can instead be made non-dischargeable.

Accelerated Bankruptcy Procedures: As an overlay to the external management process, Prime Minister Sergei Kiriyenko decreed

²⁰⁴ See *id.* Art. 3(1).

²⁰⁵ See *id.* Art. 3(2).

²⁰⁶ See Katy Daigle, *New Bankruptcy Law Updates Process*, MOSCOW TIMES, Mar. 4, 1998, available at LEXIS, News Library, Mostms File (citing example of automaker Moskvich whose dilapidated buildings and outdated equipment a court determined to be worth more than its debts).

²⁰⁷ See *New RF Bankruptcy Law Workable But Flawed*, *supra* note 198.

²⁰⁸ See Peter A. Maximov, *Russia's New Bankruptcy Law Is a Step Forward*, RUSS. AND COMMONWEALTH BUS. L. REP. Apr. 22, 1998, available at LEXIS, News Library, RCBLR File; Laurence S. Moss, *Bankruptcy Reform in Russia: The Case for Creditor Rights in Russia*, REV. AUS. ECON. 121, 137 (2000) (court's task of valuation impossible when resale market for assets non-existent).

²⁰⁹ See Federal Law # 6-FZ of January 8, 1998 on Insolvency, *supra* note 197, Art. 4(2).

²¹⁰ See *id.*

"Accelerated Bankruptcy Procedures."²¹¹ Pursuant to this decree, the debtor's creditors—especially those owed "compulsory payments," i.e., state agencies—may consolidate their claims and be represented by the Federal Service of Russia for Insolvency and Financial Rehabilitation (Service), an agency of the Russian government.²¹² Such consolidation permits a group of creditors to present a unified claim in creditors' proceedings. The Service may propose a candidate for interim manager subject to approval of the Arbitration Court.²¹³ The Creditors' Committee—which includes the Service as a member—may vote to proceed directly to receivership and use of accelerated procedures.²¹⁴ Under accelerated procedures and pursuant to a receivership plan drawn up by an external manager, the debtor's business is subject to reorganization including establishment of a new joint-stock company that acquires the debtor's assets and retains the company's jobs. Stock in the new company is sold, and proceeds from the sale are used to pay the debtor's debts.²¹⁵ But if proceeds from the sale of stock are insufficient to satisfy all creditors' claims, the arbitration manager files an application with the Arbitration Court to terminate the receivership, rule the debtor bankrupt, and open bankruptcy proceedings.

Accelerated Bankruptcy Procedures would seem useful in cases where the debtor is solvent in the sense that it owns assets worth more than its liabilities but does not have sufficient cash flow to pay its bills. Accelerated Bankruptcy Procedures accomplish little if the sale of stock in the newly formed joint-stock company does not generate sufficient funds to pay off all creditors, and new shareholders would contribute funds of that magnitude only if the debtor's assets were greater in value than its liabilities. Such a procedure might also facilitate removal of incompetent or dishonest management, as new shareholders should insist—as a condition of their making capital contributions—on acquiring control of the corporation.

In fact, Prime Minister Kiriyenko viewed the Accelerated Bankruptcy Procedures as a means of collecting from tax-dodging enterprises.²¹⁶ And indeed the law's intent is to encourage existing firms to become more efficient and competitive by facilitating the sale of inefficient firms to new owners.²¹⁷ Georgy Tal, head of the Service, has taken a cautious approach

²¹¹ See Decision of the Government of the Russian Federation No. 476 of May 22, 1998 on Measures to Increase Efficiency of Applying Bankruptcy Procedures (on file with the author).

²¹² See *id.* § 3 (Regulations).

²¹³ See *id.*

²¹⁴ See *id.* § 4 (Regulations).

²¹⁵ See *id.* §§ 5-6 (Regulations).

²¹⁶ See *Kiriyenko Introduces Accelerated Bankruptcy Procedure*, RUSS. AND COMMONWEALTH BUS. L. REP., July 1, 1998, available at LEXIS, News Library, RCBLR File.

²¹⁷ See *id.*

to use of Accelerated Bankruptcy Procedures, indicating that they should be used only in exceptional cases and pursuant to government resolution.²¹⁸

Initiation of Bankruptcy Proceedings: Several different parties may initiate a bankruptcy proceeding in an Arbitration Court.²¹⁹ The Arbitration court itself may initiate a bankruptcy proceeding if aggregate claims against a *legal entity* debtor are 500 times the minimum wage rate or if aggregate claims against a *citizen* are 100 times the minimum wage rate.²²⁰ In connection with non-performance of monetary obligations, the debtor, creditors, or the public prosecutor may initiate the proceeding.²²¹ In connection with non-performance of an obligation to make compulsory payments, the debtor, the public prosecutor,²²² the tax authorities, or other authorized bodies²²³ may initiate the proceeding.²²⁴ Federal law may authorize still others to file an application for recognition of a debtor as bankrupt.²²⁵ In the absence of creditors' objections, a legal entity may declare bankruptcy and proceed with voluntary liquidation.²²⁶ Of course, the right of any creditor to object may mitigate whatever effect this provision would have to encourage legal entities to liquidate voluntarily.

Giving power to so many representatives of the public to seek the bankruptcy of a debtor may have the salutary effect of breaking into the downward spiral of the barter economy. The new bankruptcy law makes it easier for an unpaid creditor to initiate a bankruptcy proceeding—a definite improvement over prior law under which a court had to compare the size of a debtor's assets and debts.²²⁷ The debtor's creditors may in fact have an interest in keeping the insolvent debtor afloat as in the case of company towns. The same is true of local and regional governments. In such cases, neither the debtor nor the creditor may be inclined to initiate a bankruptcy proceeding. A broader class of persons or entities who may initiate a claim

²¹⁸ See *Russia*, RUSS. AND COMMONWEALTH BUS. L. REP., Nov. 18, 1998, available at LEXIS, News Library, RCBLR File.

²¹⁹ An Arbitration Court examines bankruptcy cases. See Federal Law # 6-FZ of January 8, 1998 on Insolvency, *supra* note 197, Art. 5(1).

²²⁰ See *id.* Art. 5(2).

²²¹ See *id.* Art. 6(1).

²²² The public prosecutor's power to file an application for recognition of a debtor as bankrupt is limited to cases when he/she discovers indicia of deliberate bankruptcy, when the debtor has debts with respect to compulsory payments, when the Russian Federation, a constituent region of the Russian Federation, or a municipality is owed a monetary obligation, and when otherwise authorized by federal law. See Federal Law # 6-FZ of January 8, 1998 on Insolvency, *supra* note 197, Art. 40(1).

²²³ See *id.* at Article 32(2), which names the Pension Fund of the Russian Federation, the Federal Obligatory Medical Insurance Fund of the Russian Federation, the Social Insurance Fund of the Russian Federation, and the State Employment Fund of the Russian Federation.

²²⁴ See *id.* Art. 6(2).

²²⁵ See *id.* Art. 6(3).

²²⁶ See *id.* Art. 24.

²²⁷ See Maximov, *supra* note 208.

makes it less likely that the recalcitrance of another creditor will allow the insolvent entity to carry on. Public officials who are at least indirectly accountable to the electorate at large and who represent entities that are themselves creditors, e.g., tax authorities, may be more inclined to initiate such claims.

One unfortunate consequence of giving *all* creditors owed 500 times the minimum wage the power to initiate bankruptcy proceedings is that creditors owed small sums can initiate bankruptcy proceedings that either impede restructuring or, even worse, allow inside managers/shareholders to strip a business of its desirable assets. In the case of Moskvich, a creditor was owed the equivalent of about \$2000. The City of Moscow had earlier taken a 59% stake in Moskvich in exchange for the City's pledge to assume a remarkable \$48,000,000 in tax debt. In two years, the company had increased production from 3000 cars annually to 40,000; it had introduced new models and entered a joint venture project with Renault. The creditor obviously had something more in mind than collecting \$2000. In fact, obscure creditors owed small amounts often initiate the proceedings so that shareholders who are also secured creditors can strip the company of desirable assets.²²⁸ Companies such as Moskvich, while insolvent, may hold some very desirable assets, such as prime real estate.²²⁹ Such asset stripping obviously injures many parties, *especially* other creditors who are denied the means by which to collect on their debts. Asset stripping, if not thievery, at least constitutes a preference.

Unfortunately, there is no middle ground between facilitating bankruptcy by giving broad powers to initiate the proceeding and abuse that facilitates insider asset stripping. The statute addresses the abuse directly—both “fictional” bankruptcies and preferences. The Russian statute imposes several obligations on debtors and the managers of legal entities. The statute provides for personal liability of managers who fail in certain obligations or prefer some creditors to others. The statute also gives arbitration courts the authority to order debtors to transfer property to third persons for safekeeping in order to protect the interests of creditors.

The new bankruptcy law imposes an obligation upon debtors to file an application for bankruptcy if satisfying the claim of one or more creditors would make impossible performance of the debtor's monetary obligations to other creditors²³⁰ or if during liquidation of the debtor, the impossibility of

²²⁸ See Carol Matlack, *Asset Disposal: Russia's Boom in Bogus Bankruptcies*, BUS. WK. INT'L, (May 31, 1999), available in LEXIS, News Group File (“flood of dubious filings against corporations and banks”); Sabrina Tavernese, *Using Bankruptcy as a Takeover Tool*, N.Y. TIMES, Oct. 7, 2000, at C1 (\$5000 debts may topple firms worth millions).

²²⁹ See Sujata Rao, *Moskvich Hit With Bankruptcy Suit*, MOSCOW TIMES, Feb. 16, 1999, available in LEXIS, News Library, Mostms File, (noting that similar proceedings had been initiated against oil major Sidanko and against high-speed rail company VSM).

²³⁰ See Federal Law # 6-FZ of January 8, 1998 on Insolvency, *supra* note 197, Art. 8(1).

fully satisfying creditors' claims is established.²³¹ The debtor has only one month in which to file such an application.²³² A debtor's failure to meet this obligation subjects a legal entity's executive members of the liquidation commission to joint and several liability for obligations that arise after the mandatory time for filing.²³³ Such persons may also lose the right to occupy management positions or to conduct business activities relating to the management of legal entities.²³⁴ Individual executives and individual entrepreneurs are subject to criminal prosecution.²³⁵ This provision certainly is intended to get insolvent debtors to initiate proceedings "voluntarily" as soon as possible. If it has that effect, the provision would be a good one. On the other hand, it may encourage executives to conceal the entity's state of affairs, hardly a desirable outcome. The inertia of the barter economy—with its tight relationships between local governments and debtors, and between management and worker/shareholders—may be such that this provision will provide little incentive for debtors essentially to "turn themselves in." Moreover, individual responsibility is placed on those most likely to engage in asset stripping. There is little evidence that this provision of the law has significantly increased the number of bankruptcy filings, but at least the statute raises the stakes for those who abuse the bankruptcy process.

The new law also imposes a duty upon founders or participants of a legal entity debtor, the property owner of a debtor that is a unitary enterprise, federal executive bodies, executive bodies of constituent regions of the Russian Federation, and bodies of local self-government to take measures in a timely manner to prevent the bankruptcy of the organization.²³⁶ This provision appears to address the type of management self-dealing that weakens even a profitable corporation. In the case of founders or participants of a legal entity debtor or the property owner of a debtor that is a unitary enterprise, the duty extends to taking measures directed to the financial *recovery* of the debtor.²³⁷ Violation of this provision subjects one to liability according to federal law.²³⁸ This provision appears to require manager/shareholders to act in ways contrary to what they have always perceived to be their own self-interest. They may not bilk corporations into bankruptcy, but must affirmatively take measures to assure their solvency. On the other hand, creditors and founders of a legal entity may provide fi-

²³¹ See *id.* Art. 8(2).

²³² See *id.* Art. 8(3).

²³³ See *id.* Art. 9(1).

²³⁴ See *id.* Art. 9(2).

²³⁵ See *id.* Art. 9(3). Such persons face up to three years in jail. See Daigle, *supra* note 206.

²³⁶ See *id.* Art. 26(1).

²³⁷ See *id.* Art. 26(2).

²³⁸ See *id.* Art. 26, last unnumbered paragraph.

nancial assistance to the debtor within the framework of bankruptcy prevention measures to restore the debtor to solvency.²³⁹ The debtor may then assume an obligation to repay the one providing such assistance.²⁴⁰ That obligation ranks no lower than the obligations owing to others who extended credit of the same sort. Unfortunately, this provision gives rights to avoid bankruptcy to the very entities that will have an interest in preventing it, i.e., local governments. And local governments have in fact extended credit to legal entities that only prolonged the agony. This only reinforces the destructively symbiotic relationship between inefficient firms and local governments.

The new bankruptcy law very strictly addresses the so-called "fictional" bankruptcy.²⁴¹ A fictional bankruptcy is one in which the legal entity debtor's founders, executives, or others take actions to send the firm into bankruptcy, presumably to obtain the firm's assets—either as a creditor or by hiding them.²⁴² Such a person is subject to criminal prosecution and/or disqualification from holding a similar position.²⁴³ The latter provisions, if enforced, should preclude insiders from benefiting from a legal entity's bankruptcy. Enforcement is of course the key.

These latter provisions may be invoked in the context of a bankruptcy proceeding. In fact, they are provisions of corporate governance—imposing ongoing obligations on managers of even solvent corporations.

In addition to addressing fictional bankruptcies and preferences, the new bankruptcy law gives an arbitration court the power to secure creditors' claims by ordering the debtor to transfer securities, currency, or other property to a third party in order to conserve the debtor's property.²⁴⁴ From the time of observation proceedings, an arbitration court may also remove the debtor's executive if he/she does not take necessary measures to preserve the debtor's property.²⁴⁵ Of course, the effectiveness of this measure will depend upon the willingness of an arbitration court to use it at appropriate times. An arbitration court should make such decisions without undue influence from interested parties.

Representation of Creditors' Interests: A creditors' "meeting" and a creditors' "committee" represent the interests of all creditors during a bankruptcy proceeding.²⁴⁶ During a bankruptcy proceeding, no creditor may apply to the debtor for the purpose of seeking individual satisfaction of

²³⁹ See *id.* Art. 27(1).

²⁴⁰ See *id.* Art. 27(2).

²⁴¹ See *id.* Art. 10.

²⁴² See Daigle, *supra* note 206.

²⁴³ See Federal Law # 6-FZ of January 8, 1998 on Insolvency, *supra* note 197, Art. 10(3). The potential penalty is six years in jail; see also Daigle, *supra* note 206.

²⁴⁴ See Federal Law # 6-FZ of January 8, 1998 on Insolvency, *supra* note 197, Art. 44(2).

²⁴⁵ See *id.* Art. 58(4).

²⁴⁶ See *id.* Art. 11(4).

his/her claim.²⁴⁷ The "meeting" is comprised of creditors, tax authorities, and other authorized bodies as regards compulsory payments.²⁴⁸ Members of the creditors' "meeting" have votes in proportion to the "monetary obligations" or "compulsory payments" owed to them.²⁴⁹ A majority of the votes cast at a creditors' meeting is sufficient to adopt a decision,²⁵⁰ but institution and extension of external management, petitioning the Arbitration Court for recognition of the debtor as bankrupt, and application to the Arbitration Court for removal of the arbitration manager require a majority of the total number of votes of all competing creditors of the creditors' "meeting."²⁵¹ Creditors at a creditors' meeting may institute external management, conclude an amicable agreement, commence "competitive proceedings," i.e., the proceedings in which a determination is made concerning the amount to be paid each creditor prior to liquidation, and make decisions concerning the number of members and composition of the creditors' committee and to appeal either of their actions to the Arbitration Court.²⁵²

The distinction between votes proportional to monetary obligations or compulsory payments owed and votes accorded each creditor equally is significant. If a single creditor is owed much *and* has an interest in keeping the debtor afloat, proportional voting allows that creditor to defeat the interests of other creditors as well as the public interest in pushing non-viable firms out of business. This may be particularly likely when a local government is owed a substantial amount and has designated the debtor as one with whom others should do business. If voting is "one-creditor, one-vote," the power of such entities is of course diluted while the power of those with much less at stake is enlarged (and distorted). Moreover, debtor satisfaction of creditors through preferential payments (or satisfaction of debts by third parties (*see* discussion of Sidanko *infra*)) has the consequence of reducing or eliminating the influence of that creditor; the voting system in effect determines whether this can be done cheaply. It is possible to adopt a combination of both cumulative voting and "one-creditor, one-vote" systems, e.g., 51% of the claims and 1/3 of all of the creditors.

The creditors' meeting elects by cumulative voting²⁵³ the members of the creditors' committee who serve during the period of external manage-

²⁴⁷ *See id.* Art. 11(4).

²⁴⁸ *See id.* Art. 12(1).

²⁴⁹ *See id.* Art. 12(3).

²⁵⁰ *See id.* Art. 14(1).

²⁵¹ *See id.* Art. 14(2). If such a majority cannot be obtained, a second creditors' meeting may be called to deal with such matters, and a majority of votes present at the second meeting is sufficient if adequate notice was provided. *See id.* Art. 14(3).

²⁵² *See id.* Art. 12(2).

²⁵³ *See id.* Art. 17(2). A creditor with respect to monetary obligations or compulsory payments equal to ten times the legal minimum wage is entitled to the number of votes of the

ment and competitive proceedings.²⁵⁴ The creditors' meeting may also revoke the powers of the entire creditors' committee.²⁵⁵ The creditors' committee is comprised of no more than eleven persons²⁵⁶ who may elect their own chairman if there are fewer than six members and must elect a chairman if there are six or more members.²⁵⁷ It represents the interests of competing creditors and monitors the actions of the external manager.²⁵⁸ If there are fewer than fifty competing creditors, the creditors' meeting may decide to assume the functions of the creditors' committee.²⁵⁹ The creditors' committee may adopt a decision by a majority of votes of the total number of members of the creditors' committee.²⁶⁰ The creditors' committee may require the external manager or the competitive proceedings manager to provide information about their progress.²⁶¹ Important day-to-day oversight is entrusted to the creditors' committee. That committee is selected by cumulative voting, but the committee acts on a one-committee-member-one-vote basis. Thus the possibility of a dominant creditor with interests in preserving a non-viable firm controlling the identity of committee members exists—even though the committee itself theoretically is not subject to such dominance.

The Bankruptcy Proceeding: The Arbitration Court for the location of the legal entity debtor and the residence of its citizens has jurisdiction over the bankruptcy proceedings involving that legal entity.²⁶² To the extent that the local government controls the members of the Arbitration Court, this may be unfortunate in that such members become beholden to the parties most interested in keeping non-viable firms afloat at the expense of firms that are more efficient. A representative of the debtor's employees is a party to a bankruptcy case.²⁶³

The Russian Bankruptcy Act contemplates three stages²⁶⁴ of a bankruptcy case²⁶⁵—any one of which may be the last: observation proceedings, external management, and competitive proceedings. Hopefully the appointment of managers will reduce the incidence of company theft, i.e.,

committee members to be elected. Evidently the votes of all such creditors are equal in weight.

²⁵⁴ See *id.* Art. 17(1).

²⁵⁵ See *id.* Art. 17(1).

²⁵⁶ See *id.* Art. 16(4).

²⁵⁷ See *id.* Art. 17(3).

²⁵⁸ See *id.* Art. 16(1).

²⁵⁹ See *id.* Art. 16(2).

²⁶⁰ See *id.* Art. 16(5).

²⁶¹ See *id.* Art. 16(3).

²⁶² See *id.* Art. 29(1).

²⁶³ See *id.* Art. 30.

²⁶⁴ *Id.* Art. 23 (plus amicable agreement).

²⁶⁵ See *id.* Article 2 actually names a fourth procedure, pre-trial rehabilitation, which involves measures taken to prevent bankruptcy.

shareholder-managers stealing of assets prior to losing control of the business.²⁶⁶

First, there is the appointment of an interim manager²⁶⁷ who oversees "observation proceedings." The interim manager's functions are to:

- Monitor all of the debtor's transactions (although the debtor remains in control of its business);
- Conduct a financial analysis of the debtor company and look for signs of premeditated bankruptcy;
- Compile a list of creditors and give them notice of the bankruptcy proceeding;
- Arrange a meeting of creditors at which creditors decide whether to call for appointment of an outside manager, recommend liquidation, or work out an amicable agreement;
- Form and protect the bankruptcy estate for which he/she may forbid the debtor from conducting any transactions and go to court to void them as well as order the transfer of the debtor's property to a third party for safe-keeping; and
- Approve (without court approval) major deals undertaken by the debtor.²⁶⁸

During observation proceedings, the debtor's payments are suspended *except for* court ordered payments of wages, royalties under copyright assignments, alimony, or compensation for harm to life and health or "moral" damages—such orders having entered effect prior to the Arbitration Court's acceptance of the application to recognize the debtor as bankrupt.²⁶⁹ Payments should not worsen the financial position of the debtor.²⁷⁰ The interim manager serves only until the Arbitration Court declares the debtor bankrupt and institutes "competitive proceedings" under the auspices of a competitive proceedings manager, the creditors institute "external management," the Arbitration Court approves an "amicable agreement," or the Arbitration Court issues its order refusing to recognize the debtor as bankrupt.²⁷¹ At the same time, observation proceedings terminate.²⁷²

Only if the debtor has assets sufficient to pay court costs and the expenses of arbitration managers or one or more creditors can identify resources to pay such costs will the Arbitration Court proceed to appoint an "external manager"²⁷³ for a specified period of time. This initiates the sec-

²⁶⁶ See Daigle, *supra* note 206, quoting Yevgeny Fainshmidt.

²⁶⁷ See Federal Law # 6-FZ of January 8, 1998 on Insolvency, *supra* note 197, Art. 59(1).

²⁶⁸ See *New RF Bankruptcy Law Workable but Flawed*, *supra* note 198.

²⁶⁹ See Federal Law # 6-FZ of January 8, 1998 on Insolvency, *supra* note 197, Art. 57(1).

²⁷⁰ See Maximov, *supra* note 208.

²⁷¹ See Federal Law # 6-FZ of January 8, 1998 on Insolvency, *supra* note 197, Art. 59(2).

²⁷² See *id.* Art. 67(4).

²⁷³ See *id.* Art. 62(2).

ond stage of the bankruptcy case. Selection of the external manager is by majority vote of creditors.²⁷⁴ Even if creditors apply for competitive proceedings, the Arbitration Court may order external management if it believes that the creditors' application will harm the majority of creditors and/or that there is a realistic opportunity to restore the debtor to solvency.²⁷⁵ Thus the Arbitration Court may ostensibly act in the interest of creditors who see their own interests differently from the way the Arbitration Court sees them. This seems to be an opportunity for the Arbitration Court to delay the liquidation of non-viable entities for the benefit of a few (maybe only one) large creditor at the expense of all of the other creditors. The Arbitration Court may also be more heavy-handed in discriminating against the interests of western creditors or management, seemingly a problem in the Sidanko matter, *infra*.

The functions of the external manager are to *take control of the enterprise from the debtor and run it*, void transactions, and proceed to liquidation if he/she cannot make the enterprise profitable within twelve to eighteen months.²⁷⁶ The court may void transactions that are "detrimental" to creditors. This is an improvement over prior law which allowed for voiding only "sham" transactions, i.e., those transactions that favored one creditor over another.

External management is to last no more than twelve months, unless extended for no more than six months (unless otherwise provided by the Bankruptcy Act).²⁷⁷ The external manager essentially runs the business of the debtor.²⁷⁸ As was the case during observation proceedings, during the period of external management, the debtor's payments are suspended *except* for court ordered payments of wages, royalties under copyright assignments, alimony, or compensation for harm to life and health or "moral" damages—such orders having entered effect prior to the Arbitration Court's acceptance of the application to recognize the debtor as bankrupt.²⁷⁹ The moratorium on payments extends to imposition of fines and penalties for nonpayment of a debt that exceed the level established by § 395 of the Russian Federation Civil Code which happens to be the interest rate established by the Central Bank of the Russian Federation.²⁸⁰ This is an improvement

²⁷⁴ See *id.* Art. 71(3).

²⁷⁵ See *id.* Art. 67(4).

²⁷⁶ See *New RF Bankruptcy Law Workable but Flawed*, *supra* note 198.

²⁷⁷ See Federal Law # 6-FZ of January 8, 1998 on Insolvency, *supra* note 197, Art. 68(4), Article 68(5) (period may be less than twelve months).

²⁷⁸ See *id.* Art. 69.

²⁷⁹ See *id.* Art. 70(2).

²⁸⁰ See Civil Code of the RSFSR, § 395 (adopted by Supreme Soviet of RSFSR, June 11, 1964, amended Nov. 30, 1994, amended Jan. 26, 1996). Section 395 gives citizens the right to keep their money in state savings banks and other credit institutions and to receive interest.

over prior law under which such fines and penalties could render futile restructuring efforts.²⁸¹ The external manager has the power essentially to reorganize the debtor, including the power to refuse to perform the debtor's contracts²⁸² if performance would cause loss to the debtor²⁸³ and the power to dispose of the debtor's property—with the consent of the creditors' meeting or the creditors' committee if the disposition is a "major" transaction.²⁸⁴ The debtor's contractual counterpart may demand compensation for refusal to perform the contract.²⁸⁵ The external manager may petition the Arbitration Court to cut off the rights of "interested persons," a phrase that includes the debtor's executive body and various officers,²⁸⁶ as well to cut off the rights of any other person²⁸⁷ that arise out of transactions with the debtor during the six-month period prior to the date the application for recognition of the debtor as bankrupt is submitted to the court.²⁸⁸ Thus the external manager has the authority at this (rather late) point to stop insider management dealing. The external manager must prepare a plan for restoring the debtor to solvency that the creditors' meeting passes upon.²⁸⁹

The external management plan may provide for the sale of the enterprise, in which case the debtor's monetary obligations and compulsory payments do *not* pass to the purchaser,²⁹⁰ but all labor agreements must remain in force, and the rights and obligations of the employer do pass to the purchaser of the enterprise.²⁹¹ This provision of course reflects the Russians' obsession with the prospect of unemployment. This provision will inhibit the sale of some insolvent enterprises—although to what extent is not knowable.

External management ends when the debtor is bankrupt and it is necessary to proceed to a competitive proceeding, there is an amicable agreement, or there is a declaration that the debtor has been restored to solvency.²⁹² However, the external manager may continue to perform duties to assure a smooth transition.²⁹³

²⁸¹ See Maximov, *supra* note 208.

²⁸² See Federal Law # 6-FZ of January 8, 1998 on Insolvency, *supra* note 197, Art. 74(1).

²⁸³ See *id.* Art. 77(2).

²⁸⁴ See *id.* Art. 76 ("major" transactions include those involving property with a value equal to 20% of the book value of the debtor's assets).

²⁸⁵ See *id.* Art. 77(3).

²⁸⁶ See *id.* Art. 18(1).

²⁸⁷ See *id.* Art. 78(3).

²⁸⁸ See *id.* Art. 78(2), Article 78(4) (participant of the debtor).

²⁸⁹ See *id.* Arts. 82 and 83.

²⁹⁰ See *id.* Art. 86(1).

²⁹¹ See *id.* Art. 86(2).

²⁹² See *id.* Art. 96.

²⁹³ See *id.* Art. 96.

Either observation proceedings or external management can end with an "amicable agreement." An amicable agreement requires a majority vote of all creditors, a unanimous vote of creditors whose claims are secured by a pledge of the debtor's property, *and* the agreement of the debtor.²⁹⁴ An amicable agreement is only available if first and second priority creditors' claims are settled.²⁹⁵ Under prior law, an amicable agreement required a two thirds vote of creditors and the debtor's payment of 35% of outstanding debt within two weeks.²⁹⁶ The new law should facilitate the amicable agreement more than the prior law. Creditors whose debts are secured by a pledge of the debtor's property have third priority claims—after claims for harm to life or health, wages of persons working under a labor agreement, and royalties under copyright agreements.²⁹⁷ An amicable agreement cannot discriminate among creditors of the same level of priority.²⁹⁸ An amicable agreement is invalid if it provides preferences for specific creditors.²⁹⁹ A preferred creditor has an obligation to return anything received in the course of performance of an invalid amicable agreement.³⁰⁰

The third stage of a bankruptcy proceeding under the Russian law is "competitive proceedings." "Competitive proceedings" is the procedure whereby creditors' claims against a debtor recognized as bankrupt are satisfied proportionately.³⁰¹ The procedure is to last one year, but the Arbitration Court may extend the period by six months and beyond.³⁰² The Arbitration Court appoints one or more "competitive proceedings managers."³⁰³ The statute gives competitive proceedings manager(s) sufficient powers and responsibilities to manage the orderly liquidation of the bankrupt's estate.³⁰⁴ This includes the obligation to notify the debtor's employees of forthcoming dismissals in accordance with national labor legislation³⁰⁵ and the power to retrieve the debtor's property from those who may possess it as the result of invalid transactions.³⁰⁶ The statute requires removal from the bankrupt's estate of the social housing fund, chil-

²⁹⁴ See *id.* Art. 120(2).

²⁹⁵ See *id.* Art. 123(1); see also *id.* Art. 125(1) (arbitration court to refuse approval of amicable agreement in event of failure to satisfy first and second priority creditors).

²⁹⁶ See *Workouts May Become More Frequent in Russia*, RUSS. AND COMMONWEALTH BUS. L. REP., Feb. 10, 1999, available at LEXIS, News Library, RCBLR File.

²⁹⁷ See Federal Law # 6-FZ of January 8, 1998 on Insolvency, *supra* note 197, Art. 125(1).

²⁹⁸ See *id.* Art. 122(3).

²⁹⁹ See *id.* Art. 127.

³⁰⁰ See *id.* Art. 128(5).

³⁰¹ See *id.* Art. 2.

³⁰² See *id.* Art. 97(2).

³⁰³ See *id.* Arts. 99(1) and (2).

³⁰⁴ See *id.* Art. 101.

³⁰⁵ See *id.* Art. 101(3).

³⁰⁶ See *id.* Art. 101(4).

dren's pre-school institutions, and other facilities of public infrastructure and their assignment to an authorized local government.³⁰⁷ The competitive proceedings manager(s) must make the assignment without conditions, and the existing budgets remain sources of financing for the support of such facilities.³⁰⁸ Local government officials must accept the obligation of maintaining such facilities or face administrative or other liability.³⁰⁹ These provisions are good in that they get social safety net provisions out of the hands of debtors—but bad in the sense that the responsibility is passed to another entity not necessarily capable of handling it, yet often capable of inhibiting the very bankruptcy that makes such a transfer necessary. To that extent, the local government has a considerable incentive to perpetuate non-viable enterprises that will continue to assume such obligations, especially in company towns. Moreover, the content of the safety net seems not to matter—and it is likely that the safety net is much broader than local governments can responsibly handle.

The Bankruptcy Law requires that court costs, expenses associated with remuneration of the arbitration manager, and creditors' claims arising during observation proceedings, external management or competitive proceedings be paid first.³¹⁰ The Bankruptcy Law establishes the following subsequent priorities: first, claims for liability for harm to life or health;³¹¹ second, severance and wages of persons working under a labor agreement and payment of copyright royalties; third, obligations secured by a pledge of the debtor's property; fourth, compulsory payments to the budget and to extra-budgetary funds; and fifth, payments to other creditors.³¹² Notice that "secured" creditors are merely another class of creditors albeit a preferred class. This likely will inhibit commercial creditors from loaning money to any but the most credit-worthy of debtors. Moreover, the secured debt is what is important, not the property securing the debt. A secured creditor does not recover the collateral securing the debt. A secured creditor's third priority claim exists only to the extent of the debt actually secured by a pledge,³¹³ but the extent of that debt may be satisfied both from the property securing the debt and from other property not the subject of the pledge.³¹⁴ This is not sufficient protection to encourage credit transactions. Insiders' secured claims are not preferred over compulsory payments or payments to other creditors.³¹⁵ This difference in priority for secured

³⁰⁷ See *id.* Art. 104(4).

³⁰⁸ See *id.* Art. 104(5).

³⁰⁹ See *id.* Art. 104(6).

³¹⁰ See *id.* Art. 106(1).

³¹¹ See *id.* Art. 106(2). Periodic payments are to be capitalized. See *id.* Art. 107.

³¹² See *id.* Art. 106(2).

³¹³ See *id.* Art. 109(1).

³¹⁴ See *id.* Art. 109(3).

³¹⁵ See *id.* Art. 111(1).

claims between a firm's founders and other creditors is of course appropriate in that it treats the founders' interests more like equity and might make asset stripping less likely. Creditors' unsatisfied claims resulting from insufficient debtor's assets are discharged.³¹⁶ It is here that the bankruptcy law should reflect the policy of favoring the actual payment of obligations: arising from harm to citizens' life or health, to pay copyright royalties, and to pay fines or penalties incurred for non-performance or improper performance of a monetary obligation. Such obligations should be *non-dischargeable*. Such non-dischargeability might have the effect, say, of causing potential creditors to avoid making loans to those who pirate copyrighted compact disks.

Town-Forming Organizations: Some special procedures must be observed in the case of so-called "town-forming organizations," i.e., a legal entity whose employees plus their family members comprise half the population of a populated locality or an organization that employs more than 5000 people.³¹⁷ When a "town-forming organization" is the debtor, the body of local self-government becomes a party to the case³¹⁸ and may petition the Arbitration Court to institute external management.³¹⁹ Institution of external management of course prolongs the process of bankruptcy, even for those debtors who clearly are insolvent. If the Russian Federation, a constituent region of the Russian Federation, or a municipality guarantees the debtor's obligations, that party may propose a candidate to the Arbitration Court to be the external manager,³²⁰ but also becomes jointly and severally liable for the debtor's obligations.³²¹ To the extent that the Arbitration Court accedes to the wishes of such a government body, the likelihood of appointment of a candidate receptive to prolonging the existence of the debtor increases. Such external management may be extended by the Arbitration Court for up to *ten* years³²² at the petition of the body of local self-government or an appropriate federal executive body or the executive of a constituent region of the Russian Federation, provided that the debtor and its guarantor begin settlements with creditors within one year.³²³ A financial recovery plan for a town-forming organization may be the basis of extending the period of external management.³²⁴ The Russian Federation, a constituent region of the Russian Federation, or a municipality has the right before the end of external management of the "town-forming" or-

³¹⁶ See *id.* Art. 114(5).

³¹⁷ See *id.* Art. 132.

³¹⁸ See *id.* Art. 133(1).

³¹⁹ See *id.* Art. 134(1).

³²⁰ See *id.* Art. 134(2).

³²¹ See *id.* Art. 134(3).

³²² See *id.* Art. 135(3).

³²³ See *id.* Art. 135(1).

³²⁴ See *id.* Art. 135(2).

ganization to settle with all creditors in any manner provided by Federal law.³²⁵ The "town-forming" organization may be sold in the course of external management proceedings at the petition of the executive body of a constituent region of the Russian Federation, an appropriate federal executive body, or a body of local self-government³²⁶ for the purpose of satisfying creditors' claims,³²⁷ but only upon certain mandatory conditions: preservation of at least 70% of employees' jobs, retraining employees if the enterprise's activity changes, and other terms and conditions established with the consent of the creditors' meeting.³²⁸ Certainly these conditions will inhibit such sales. Otherwise the debtor's enterprise is subject to sale at auction.³²⁹ Moreover, the arbitration manager must offer the enterprise for sale as a single property complex in the first round of tenders.³³⁰ The "town-forming" provisions of the statute virtually guarantee that any local government can (try to) keep a non-viable firm in business for at least ten years. These provisions may prove disastrous to the development of a market economy that rewards only efficient producers.

The "town-forming" provisions are intended to prevent high profile bankruptcies of entities descended from Soviet era enterprises; a domino effect emanating from such bankruptcies causes concern.³³¹ Such provisions are nevertheless very counter-productive. They greatly inhibit change—and rigid aversion to change results in more and more stagnation, thereby perpetuating the downward economic spiral. Not only are inefficient firms kept afloat—it is the *large* inefficient firms that are kept afloat. This of course occurs at the expense of more nimble, smaller, and efficient enterprises.

Other Provisions: The bankruptcy statute contains provisions that govern specific industries, notably agricultural organizations,³³² credit organizations,³³³ insurance organizations,³³⁴ and professional participants in securities markets.³³⁵ As such entities are not notoriously a part of Russia's virtual economy—at least not as described herein, this article omits any dis-

³²⁵ See *id.* Art. 136(1).

³²⁶ See *id.* Art. 137(2).

³²⁷ See *id.* Art. 137(1).

³²⁸ See *id.* Art. 137(3).

³²⁹ See *id.* Art. 137(4).

³³⁰ See *id.* Art. 138(1).

³³¹ See *New RF Bankruptcy Law Workable but Flawed*, *supra* note 198.

³³² See Federal Law # 6-FZ of January 8, 1998 on Insolvency, *supra* note 197, Arts. 139-40.

³³³ See *id.* Arts. 141-43. Bankruptcy of credit institutions is now governed by Federal Law # 40-FZ of February 26, 1999.

³³⁴ See Federal Law # 6-FZ of January 8, 1998 on Insolvency, *supra* note 197, Arts. 144-47.

³³⁵ See *id.* Arts. 148-51.

cussion of those provisions. Moreover, neither are citizens,³³⁶ individual entrepreneurs,³³⁷ or peasant enterprises³³⁸ a significant part of the downward spiral of the barter economy.

Comment: It is difficult to overstate the importance of an effective bankruptcy law in Russia. One commentator noted that an effective bankruptcy law is probably as important to the Russian economy as privatization itself.³³⁹ A bad bankruptcy law—or a good bankruptcy law that is badly administered³⁴⁰—inhibits activities such as lending and investing, the very activities that stimulate economic activity and growth. Capital infusions should only be available to restructure viable companies.

Even if a provision is aimed at curbing an obvious abuse, it will not necessarily work as well as intended. Fine-tuning³⁴¹ the criminal liability of greedy manager/shareholders will accomplish little if those provisions are not enforced. Of course it is good that such provisions are present. But more effective might be giving real and significant powers to shareholders to bring shareholder derivative suits before judges sophisticated enough to honor shareholder rights.³⁴² There is considerable room for improvement in bankruptcy as the legal system processed only about 2000 bankruptcies per year under the prior law.³⁴³ Nearly *half* of the businesses in Russia may qualify for bankruptcy.³⁴⁴ Of course a real threat of bankruptcy would prompt many businesses to pay bills so as to avoid bankruptcy. Unfortunately, the “town-forming organization” provisions seem designed to perpetuate for up to ten years inefficient firms. Realistically, the ten-year limitation seems so long that it is not really a limitation at all.

In the context of its request for financial support from the International Monetary Fund, the Russian government said the following:

³³⁶ See *id.* Arts. 152-63.

³³⁷ See *id.* Arts. 164-66.

³³⁸ See *id.* arts. 167-73.

³³⁹ See *New RF Bankruptcy Law Workable but Flawed*, *supra* note 198 (quoting Tom Cumming).

³⁴⁰ Cf. Matlack, *supra* note 228 (noting unscrupulous judges and external managers who ignore the will of creditors).

³⁴¹ In this case, “fine-tuning” is akin to “throwing the book at.”

³⁴² Professors Black and Kraakman suggested a “self-enforcing” model as the appropriate approach to Russian corporate law that does not depend upon courts but rather upon incentives for voluntary compliance with laws that protect the interests of outside investors and minority block-holders. See Bernard Black and Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911 (1996).

³⁴³ See *New RF Bankruptcy Law Workable but Flawed*, *supra* note 198. The actual numbers were 9 in 1993, 300 in 1994, 1108 in 1995, 2700 in 1996, and 4600 in 1997. See Daigle, *supra* note 206.

³⁴⁴ See Daigle, *supra* note 206, citing Yevgeny Fainshmidt (of 2.5 million businesses in Russia, 800,000 defunct and 400,000 more qualify for bankruptcy).

53. The existence of an adequate bankruptcy law and the ability to employ it when necessary is perhaps the fundamental element underlying the enforcement of hard budget constraints. To enhance the efficacy of the bankruptcy process, the government has confirmed its commitment to make full use of such procedures and, to this effect, will rescind the government directive of January 27, 1999, to cease initiating bankruptcy proceedings against tax debtors. Further, except for the banking sector, the government will refrain from submitting to the State Duma draft laws which envisage special bankruptcy terms for any type of debtor, and will ensure the independent status of the Federal Insolvency and Financial Rehabilitation Service ("FIFRS") and take measures to complete its staffing.

54. To address shortcomings of the current Law on Insolvency (Bankruptcy), the government has submitted to the Duma with a view to ensuring passage by October 31, 1999, of amendments to eliminate the bias in the law towards reorganization rather than liquidation of enterprises, eliminate court discretion in overruling the creditors' decision to liquidate the debtor enterprise; and provide for the participation of the state in bankruptcy proceedings at all stages where relevant for the protection of the public interest. The amendments will also provide a legislative basis for creditors to utilize bankruptcy procedures in a special accelerated manner, including faster introduction of external management of enterprises under bankruptcy. Finally, to enhance the incentive of managers to maintain solvency of their enterprises and to abide by the Law on Insolvency, the government will submit to the State Duma, by November 30, 1999, a draft law providing for increased personal financial liability and management disqualification for improper conduct by management resulting in the insolvency of enterprises managed by them.³⁴⁵

No amendments to Russia's bankruptcy laws have been forthcoming.³⁴⁶ The bankruptcy law contemplates that the Interim Manager and the External Manager will draft and implement rehabilitation plans, with ample if not generous time constraints. The town-forming provisions, which deal with only the larger firms and hence the firms that can be the greatest drag on the economy allow up to ten years for restructuring. This may turn out to be essentially a meaningless provision that will have no effect in that economic realities will overtake such firms long before the expiration of ten years.

³⁴⁵ *Statement of the Government of the Russian Federation and Central Bank of Russia on Economic Policies*, July 13, 1999, at <http://www.imf.org/external/np/loi/1999/071399.htm>.

³⁴⁶ This is not entirely accurate. In spring 2000, President Putin vetoed a bill that the Duma and Federal Council had approved that would have, among other things, lengthened receiverships to 2½ years, lengthened the definition of insolvency of an enterprise to six month arrears, and required that an enterprise's accounts payable equal five times the minimum wage rate. In chronological order, see Interfax News Agency, *Duma Amends Bankruptcy Law*, Feb. 29, 2000, available at LEXIS, News Library, Interfax Russian News; *Laws*, ZVEZDA, Mar. 1, 2000; Interfax News Agency, *Duma's Property Committee Against Changes in Bankruptcy Law*, Mar. 21, 2000, available at LEXIS, News Library, Interfax Russian News; Interfax News Agency, *Putin Rejects Parliament-Approved Bankruptcy Law Changes*, Apr. 25, 2000, available at LEXIS, News Library, Interfax Russian News.

Such firms will either collapse under the weight of their debt and mismanagement or their assets will be picked clean by smaller, more nimble, and efficient enterprises.³⁴⁷ In the United States, barter is not the means by which insolvent firms may continue to languish. Restructuring under Chapter XI occurs when a firm's vital signs are not as desperate as those same signs are for a firm that must resort to barter and tax arrears to continue its existence. Therefore, the bankruptcy law of Russia as enforced *should* have a greater bias towards liquidation than toward restructuring and rehabilitation than, say, the counterpart laws of the United States.

B. Legal Environment and the Depoliticization of Business

Russia is not a country lacking in abundant natural resources or a capable labor pool. Nevertheless, it remains an emerging economy. A major cause of this has been Russia's governments—local and national. The reason poor countries fail to acquire wealth lies “in the way poor countries are governed, rather than in their natural disadvantages or in unfair treatment by the rich.”³⁴⁸ Russia's governments—local and national—have contributed significantly to the country's economic stagnation,³⁴⁹ as has been indicated throughout. The inequality of economic opportunity³⁵⁰ caused by unequal access to government favors and handouts is a political problem, not an economic problem.³⁵¹

Industrial restructuring . . . requires policy and institutional actions on many fronts. These actions include eliminating state protection in order to strengthen enterprises; enhancing the mobility of labor and capital; and increasing the availability of resources such as information, skills, and finance.³⁵²

³⁴⁷ Cf. Feifer, *supra* note 12 (noting City of Moscow's massive allocations of money to Moskvich and ZiL automakers who have no restructuring plan and no real hope for survival; Renault now uses a section of Moskvich's plant to produce its cars with no further participation by Moskvich).

³⁴⁸ Special Section, *Freedom's Journey: A Survey of the 20th Century*, “Free to Be Poor,” *ECONOMIST*, Sept. 11, 1999, at 27, 28 (table shows Russia ranks 84th out of 121 countries for economic freedom – behind such countries as Haiti, Namibia, Bulgaria, and Uganda); see also Akin, *supra* note 171 (according to “Transition Report 1999,” the European Bank for Reconstruction and Development, Russia had fourth worst governance rating).

³⁴⁹ An old adage says that, “The only economics in Russia is politics.” Gary Peach, *The Analyst: Aksyonenko Railroads Russia's Magnificent Seven*, *MOSCOW TIMES*, Nov. 23, 1999, available at LEXIS, News Library, Mostms File; cf. Feifer, *supra* note 12 (describing political considerations that prompt City of Moscow to keep two hopeless automakers, Moskvich and ZiL, afloat).

³⁵⁰ See Akin, *supra* note 171 (“Russia's Gini coefficient – a standard measure of inequality – grew faster than almost every other country in the former Soviet bloc”).

³⁵¹ See Peter Henderson, *Politics Seen at Fault for Weak Economy*, *MOSCOW TIMES*, Sept. 22, 1999, available at LEXIS, News Library, Mostms File, quoting Michael Obermayer.

³⁵² See Atiyas, *supra* note 57, at 195.

Russia's governments must improve the legal environment of the country and depoliticize business.³⁵³

In theory, ownership and control of a corporation resides with the corporation's shareholders. When ownership of the corporation is diffuse, i.e., there are many shareholders with no one of them holding a sufficient number of shares to exercise control alone, a takeover (or threat of a takeover) is the ultimate form of control over bad corporate management. In the absence of a takeover, corporate reorganization or bankruptcy then operates to check mismanagement. In some countries, e.g., Germany and Japan, banks' investments have made them the focal point of control over corporate management.³⁵⁴ And in some countries, the state has assumed a significant role in checking corporate mismanagement.

It would seem that a market-based system of control would achieve the most appropriate, i.e., efficient, level of corporate control. This would be control through stock ownership that could be transferred to other owners. Transfers of takeover magnitude become attractive when for whatever reason, including and especially mismanagement of the corporation, the value of the corporation's shares sinks to levels that make purchase of a sufficient number of shares to effectuate a takeover inexpensive *relative* to the value of competing investments.

In Russia, neither banks nor the state have thus far shown the inclination to check mismanagement of many of the country's privatized firms. Emergence of financial industrial groups ("FIGSs") in the loan-for-shares programs did not spur banks to invest wisely and control mismanagement.³⁵⁵ Moreover, some characteristics of many firms that this article has identified include non-viability, insufficient capital, a small and identifiable group of shareholders (i.e., employees and managers), shareholders whose

³⁵³ Black, Kraakman, and Tarassova identify

three main failures in the Russian privatization effort. First, mass privatization of large enterprises is likely to lead to massive self-dealing unless...a country has a good infrastructure for controlling self-dealing...

Second, the profit incentives to restructure privatized enterprises (instead of looting them), and to create new businesses that could draw workers from shrinking enterprises can be swamped by a hostile business environment. In Russia, that environment includes a punitive tax system, official corruption, organized crime, an unfriendly bureaucracy, and a business culture in which skirting the law is seen as normal, even necessary behavior...

Third, corrupt privatization of large firms can compromise future reforms...in a vicious circle, dirty privatization...reinforces corruption and organized crime, as the new owners turn their wealth to the task of buying judges and government officials...[T]he public comes to see privatization (and, by inference, other market reforms) as connected with self-dealing, corruption, and organized crime.

Bernard Black, Reinier Kraakman, and Anna Tarassova, *Russian Privatization and Corporate Governance: What Went Wrong?*, 52 STAN. L. REV. 1731, 1734-35 (2000).

³⁵⁴ See Atiyas, *supra* note 57, at 198 (noting that institutions for controlling corporate management include stock market, banks, and the state).

³⁵⁵ See *Virtual Reality: Barter Is the Rule in Russia - and That Has a Price*, *supra* note 85 (banks themselves were mismanaged).

interest is not necessarily profit maximization but job preservation, and an attitude of management that a firm is its private fief. Firms with this profile are most unlikely to be desirable takeover targets. Takeover of a firm would only occur if the raider believes that it can reap significant profits through better management and reorganization. The description of *many* Russian firms is such that no one perceives a diamond in the rough.

Control of corporate management of Russian corporations will arrive when government(s) allow the competitive playing field to be level and allow the market to discipline the inefficient and worse. Specifically, restructuring and bankruptcy—or the threat of restructuring and bankruptcy—will be the mechanisms that initially check management abuses.

The Russian government must stop extending loans, credits, and subsidies based on political considerations.³⁵⁶ It is far from certain that companies that lose the benefit of government loans, credits, subsidies, and/or contracts will not be responsive. Rostelmash, a giant holdover from Soviet times that manufactures combines, has responded to the drying up of government handouts by restructuring—which has included unloading some unprofitable enterprises and formation of fourteen “daughter” companies, i.e., subsidiaries.³⁵⁷ Private investment will only occur if investors have some measure of control over a firm,³⁵⁸ so firms must be made to be responsive to profit maximization, not political wishes.

Shares must be transferred to shareholders who are concerned with profit maximization. Corporate managers must be made responsive to such shareholder wishes.³⁵⁹ And even the transfer of shares to persons who care more about profits than the personal aggrandizement of current management will only occur if firms are viable. Potential investors would no doubt judge many unstructured single-plant corporations as not viable. Rather than intervene in the market to preserve such firms at the expense of efficient firms, government agencies, e.g., the central bank or the Ministry of Finance, must defer to a privately operated, open and transparent,³⁶⁰ stock market.³⁶¹

As governance replaces government, the need for strong regulation of securities markets will continue, for without full disclosure of the ownership and fi-

³⁵⁶ See BOYCKO, SHLEIFER & VISHNY, *supra* note 10, at 130-31.

³⁵⁷ See Yevgenia Borisova, *Rostelmash Tackles Massive Restructuring*, MOSCOW TIMES Sept. 28, 1999, available at LEXIS, News Library, Mostms File.

³⁵⁸ See BOYCKO, SHLEIFER, & VISHNY, *supra* note 10, at 133.

³⁵⁹ “Shareholders need firmer and clearer control over corporations in Russia than they do elsewhere because many Russian managers still consider themselves to have a right to complete control.” BLASI, KROUMOVA & KRUSE, *supra* note 6, at 120.

³⁶⁰ See *id.* at 165 (so that shareholders will install board of directors that adopts a viable restructuring strategy).

³⁶¹ See BOYCKO, SHLEIFER, & VISHNY, *supra* note 10, at 134

nancial condition of the country's new corporations, outsiders are unlikely to invest in them.³⁶²

Changes such as these would initiate the process of taking power from those who currently have it, and who do not want to lose it.³⁶³ Such power is a source of personal wealth.³⁶⁴ The Russian revolution of 1992 was a "velvet" revolution.

The Communist *nomenklatura* handed over political power practically without a shot in exchange for effective ownership of the state assets that they had administered on the Communist Party's behalf. When the music of communism stopped, they kept their chairs.

[G]ranted complete freedom of political participation, the former Communist *nomenklatura* successfully deployed its unmatched organizational resources, skills, and solidarity to thwart and dilute the capitalist transition.³⁶⁵

As one critic noted, "[t]he sad truth is that any country shedding communism has to contend with political volatility."³⁶⁶

Russian governments must bind themselves to rules that do not permit personal aggrandizement. Rather they must affect the governed in a formal and impersonal manner.³⁶⁷ Great responsibility devolves upon the electorate. Democracy, of which there is little or no tradition in Russia,³⁶⁸ im-

³⁶² See BLASI, KROUMOVA & KRUSE, *supra* note 6, at 120.

³⁶³ See *Freedom's Journey: A Survey of the 20th Century*, "Free to Be Poor," *supra* note 348, at 28 ("Government needs to set a clear and predictable regulatory and macroeconomic climate: protecting property rights, enforcing the law, avoiding inflation and, just as important, not grabbing all the money for itself").

³⁶⁴ See ECONOMIST, *supra* note 30, at 17, 18 ("ex-communists used legal, semi-legal and illegal means to turn power into wealth, and then wealth into power").

³⁶⁵ See Aron, *supra* note 22.

³⁶⁶ BOYCKO, SHLEIFER & VISHNY, *supra* note 10, at 155.

³⁶⁷ See Nichols, *supra* note 168, at 244:

Institutions can be characterized and categorized in a number of ways. One very important distinction is between institutions that operate in an impersonal, formal manner and those that operate in a more personal, relational manner. The distinction between formal and relational is best framed in terms of how each type of institution facilitates relationships.

The distinguishing feature of a formal institution is its personality. Persons who facilitate relations through a formal institution need not have any prior relationship with one another. ...

The distinguishing feature of a relational institution on the other hand, is its emphasis on pre-existing relationships or the status or position of persons.

³⁶⁸ See Strobe Talbott, *The New Russia Special Report: A Miracle Wrapped in Danger*, TIME, Dec. 7, 1992 at 34.

Russia is actually in the throes of three transformations at once: from totalitarianism to democracy, from a command economy to a free market and from a multinational empire to a nation state. ... Russia is trying to cast off, virtually overnight, the legacy of more than a thousand years of absolutism; and it is trying to create, virtually from scratch, the institutions, traditions and political culture associated with the rule of law and popular government.

Id.; see also Aron, *supra* note 22 (coincident emergence of Russian capitalism with electoral democracy differs from pattern of western countries where capitalism developed first).

poses upon the electorate a responsibility to demand accountability from leaders.³⁶⁹ In some cases, real accountability may lead to counter-intuitive results. Government measures to preserve jobs may appear to be the better course, but in fact, such measures should be avoided. The essence of a market economy or capitalism as described herein, i.e., maximization of value, is the very thing that Russian governments have turned their backs on. They do not seek value maximization—rather they pursue other goals, some worthy and some not so worthy, but all counter-productive.

The solution to Russia's problems must come from within. The events of the late 1990s have made clear though that there are no easy solutions. Russia's choice to become a Western-style democracy "will not be made on a single day by a coup or an election. Rather, it will evolve through the many decisions made by Russia's millions of people."³⁷⁰ The cost of transforming an economy from a centrally planned one to a market economy are enormous. Moreover, these costs cannot be borne simply with massive infusions of money.

Russia is in transition, in limbo. Such a position is a bad place to be and a good place to moving away from.³⁷¹

[Countries such as Russia] that have introduced partial reforms have begun the process of dismantling the state's capacity to govern the economy according to the requirements of the command system without developing the new institutions on which a market-based form of governance could be established.³⁷²

Russia must adapt to as well as adopt market oriented rules of law. A law is never better than, and rarely worse than, the people who administer it.³⁷³

The paper here traces the recent history of two matters—one involving the Sidanko Oil Company and the other involving the Lomonosov Porcelain Factory. To varying degrees, these matters illustrate the problems of law and politics at work in Russia's transition to a market economy.

³⁶⁹ See Akins, *supra* note 171 (need for "ground up" political consensus; lack of political consensus about making Russian economy a market economy).

³⁷⁰ Yavlinsky, *supra* note 70, at 67.

³⁷¹ See Aron, *supra* note 22 (Perestroika "left Russia in the worst of two worlds: between the fatally undermined command economy and a still suppressed market").

³⁷² Akin, *supra* note 171 (quoting EBRD "Transition Report 1999").

³⁷³ See Maria Rozhkova & Antony Robinson, *Alfa's Aven Criticizes Lack of Local Ethics*, MOSCOW TIMES, Apr. 22, 2000, available at LEXIS, News Library, Mostms File (Alfa Bank's president Pyotr Aven identifies "'soft-rights' that allow bureaucrats to interpret the law as they see fit ... as a major source of government corruption").

1. Example: the Matter of Sidanko Oil Company³⁷⁴

In late 1997 British Petroleum invested nearly \$750 million in Sidanko Oil Company (Russia's fourth largest oil company) and its various ventures, thus making BP by far the largest foreign investor in Russia. Of that amount, \$571 million was for BP's stake in Sidanko itself. Prior to BP's making this investment, UNEXIMbank (owned and controlled by oligarch Vladimir Potanin) owned about 95% of Sidanko. Sidanko is actually a holding company that controlled twelve trading companies and three specialized firms. Some of Sidanko's holdings are quite valuable because of what they own or control, notably Chernogorneft, Sidanko's main production unit. Sidanko (or its trading companies) no doubt engaged in unrealis-

³⁷⁴ These paragraphs were derived from news stories reporting on a day-to-day basis. The following is a selected list of sources in chronological order: *British Petroleum to Buy into Russia's Oil Holding*, ITAR-TASS, Nov. 17, 1997 (10% of Sidanko and 45% of Sidanko's 60% stake in Russia-Petroleum); Dmitry Zhdannikov, *Focus - Russia's Sidanko Faces Bankruptcy Suit*, REUTERS NEWS RELEASE, Jan. 29, 1999; Sebastian Alison, *Russian Court to Decide on Sidanko Oil Firm Tuesday*, REUTERS NEWS RELEASE, May 17, 1999; *Tyumen Oil Says Keen to Buy Bankrupt Sidanko Subsidiary*, REUTERS NEWS RELEASE, June 3, 1999; *Russian Tyumen Offers to Buy Part of Sidanko Debt*, REUTERS NEWS RELEASE, July 7, 1999; *Focus - Sidanko Shareholders Reach Debt Agreement*, REUTERS NEWS RELEASE, July 16, 1999; Sebastian Alison, *Feature - Problems Mount for Foreigners in Russian Oil*, REUTERS NEWS RELEASE, Aug. 30, 1999; David Kramer, *Ex-Im Scandal; Bank Has History of Bad Russian Debt*, WASHINGTON TIMES, Oct. 21, 1999, at A23; Sebastian Alison, *Focus - Tyumen Buys Sidanko Unit and Thwarts BP Amoco*, REUTERS BUS. REP., Oct. 21, 1999; *Russian Sidanko Says Sale of Its Oil Unit Illegal*, REUTERS NEWS RELEASE, Oct. 22, 1999; Sebastian Alison, *BP Amoco Says May Pull out of Russia*, REUTERS BUS. REP., Nov. 4, 1999; Meera Selva, *City: BP Amoco Angered by Russian Sale Ruling*, DAILY TELEGRAPH, Nov. 27, 1999; *Russia - Rules of War*, ECONOMIST, Dec. 4, 1999, at 65; Brian Humphreys, *Sidanko Still Mired After Tyumen Deal*, MOSCOW TIMES, Jan. 15, 2000, available at LEXIS, News Library, Mostms File; Valeria Korchagina, *Court Frees Sidanko From Bankruptcy*, MOSCOW TIMES, Jan. 29, 2000, available at LEXIS, News Library, Mostms File; News Release, *EBRD Reaches Out of Court Settlement with Chernogorneft*, MOSCOW TIMES, May 26, 2000, available at LEXIS, News Library, Mostms File (\$50 million loan to Chernogorneft repaid for estimated \$22 million after EBRD lost 17 court rulings); Igor Semenenko, *A Guide to the Oil Majors*, MOSCOW TIMES, June 20, 2000, available at LEXIS, News Library, Mostms File; Alexander Tutushkin and Yelizaveta Osetinskaya, *Sidanko's New Manager Locked Out of Subsidiary*, MOSCOW TIMES, July 26, 2000, available at LEXIS, News Library, Mostms File; Lyuba Pronina, *Ex-Foes TNK, Sidanko Mull Merger*, MOSCOW TIMES, Aug. 4, 2000, available at LEXIS, News Library, Mostms File; Lyuba Pronina, *Sidanko Losing Control Over Varyegannestegaz*, MOSCOW TIMES, Aug. 9, 2000, available at LEXIS, News Library, Mostms File; Alla Startseva, *Sidanko Shareholders Approve TNK Deal*, MOSCOW TIMES Aug. 26, 2000, available at LEXIS, News Library, Mostms File (Sidanko shareholders approve issuance of sufficient shares to give Tyumen 25% + 1 of all shares and BP Amoco sufficient shares to maintain its 10% stake); Anna Raff, *Chernogorneft Drops TNK Lawsuit*, MOSCOW TIMES, Jan. 22, 2001, available at LEXIS, News Library, Mostms File; cf. Patrick Connoles, *TNK Loan Approved After Albright Blessing*, MOSCOW TIMES, Apr. 8, 2000, available at LEXIS, News Library, Mostms File (U.S. Export Import Bank approved \$500 million in loan guarantees for Tyumen to purchase U.S. made equipment and services and to upgrade other facilities).

tic transfer pricing whereby it bought what Chernogorneft had to sell at artificially low prices and sold at much higher market prices. As a result, Chernogorneft owed substantial debts, but also possessed valuable resources that should have made it quite profitable.

Potanin appointed Zia Bazhayev to run Sidanko; Bazhayev ran up substantial debts until he left the firm in March 1998. Sidanko was forced into bankruptcy at the behest of a relatively small creditor because it too had substantial debt (\$343.3 million), over half of it owed to its own shareholders. Sidanko also owed substantial amounts to western creditors such as the European Bank for Reconstruction and Development ("EBRD") and the United States Ex-Im Bank. Chernogorneft was also later forced into bankruptcy. Sidanko's shareholders/creditors undertook to devise a restructuring plan that would keep the company—and its most valuable units intact.

Sidanko has been subject to some of the more "interesting" aspects of Russian bankruptcy. There has been an "us versus them" mentality prevailing in many of the proceedings as (some) western creditors as well as BP Amoco seek to preserve the company intact and make it a functioning and profitable enterprise worthy of their investments, while Russian interests (not necessarily creditors) seek to maintain local control of the company, to keep Sidanko's least desirable units from becoming the wards of local governments, and to transfer ownership of Chernogorneft to a Russian company—thereby breaking up Sidanko to the great injury of BP Amoco and one of the "oligarchs," Vladimir Potanin.

A competitor, the Tyumen Oil Company, saw an opportunity for itself in Sidanko's financial woes. Tyumen was clearly interested in acquiring Chernogorneft and did not particularly care about the financial well-being of Sidanko. In a western country, such an entity might wait for the sale of the bankrupt's estate and purchase assets (cheaply) at the bankruptcy sale. In Russia, an entity such as Tyumen can take the initiative to obtain the bankrupt's most desirable assets. Tyumen has been able to a substantial degree to control the bankruptcy proceedings. It has done this by purchasing for itself a seat at the creditors' table by paying various of Sidanko's debts to—in some cases—certain carefully selected creditors. By doing this, Tyumen has removed some of the creditors who might have opposed its desire to acquire Chernogorneft thereby breaking up Sidanko. Tyumen succeeded in having the Arbitration Court appoint its choice of an external manager, even though prior to Tyumen's presence at the creditors' table, the other creditors had agreed on a particular external manager who was more "objective" in dealing with the interests of western creditors. Specifically, Tyumen purchased the debts owing by either Sidanko or Chernogorneft to the United States Ex-Im Bank, the EBRD, and the German bank, WestLB. Perhaps as a reward, the United States Ex-Im Bank has guaranteed substantial loans to Tyumen, which of course greatly aided Tyumen in its takeover efforts.

Local courts have taken sides in this takeover battle in the ways that they can. On July 29, 1999, a court in Nizhnevartovsk, Chernogorneft's western Siberian base, ruled that the EBRD's registered debt should be reduced from \$35 million to \$26 million! The effect of this reduction was a preference for non-western creditors. Moreover, the reduction reduced the EBRD's voting rights at the creditor's meeting, thereby proportionately increasing the voting rights of other creditors. Even while Sidanko creditors apparently were working towards an amicable settlement whereby all creditors would be paid in full and existing shareholders, especially BP Amoco, would infuse more capital into Sidanko, Tyumen was busy obtaining the assets of both Chernogorneft and Kondpetroleum (another Sidanko holding) at auctions that it was able to get courts to order and at which any interests opposed to itself were not allowed to be present. Tyumen bought Kondpetroleum's assets at auction for \$52 million; the notional starting price for this subsidiary was \$145 million. Its North Sea oil reserves were valued at about 400 times what Tyumen paid. Tyumen bought Chernogorneft's assets at auction for \$176 million; Chernogorneft in 1998 had output worth \$1.2 billion at current high oil prices. Chernogorneft's debts had soared under the watchful eye of Tyumen's hand-picked external manager, thereby reducing the value of the company.

Not surprisingly, BP Amoco has not viewed these developments with much favor. It has been forced to write off \$200 million of its \$571 million investment. BP Amoco in December 1999 was able to work out a settlement with Tyumen whereby Tyumen agreed to return Chernogorneft's assets to the Sidanko fold in return for a 25% plus one share blocking stake in Sidanko.

The process may be repeated as 76% of the debt of another Sidanko subsidiary, Varyeganneftegaz, has been acquired by an Alyans Group subsidiary. Sidanko claims that it has paid all of Varyeganneftegaz's debts, to which Alyans argues that Sidanko had no agreement with Varyeganneftegaz on debt repayment and that such an agreement would be subject to approval by the creditors' meeting. The Khanty-Mansiisk arbitration court has appointed Alyans's candidate as external manager. Varyeganneftegaz processes 2.5 million tons of oil per year. This dispute has not been resolved.

In most countries, the developments in the Sidanko matter would be legally unthinkable. The bankruptcy itself was initiated by what appeared to be an insignificant creditor—which is often a prelude to asset-stripping by insiders. The possibility of looting requires that non-favored creditors move quickly in order to preserve the bankrupt's estate; the procedures available to those who seek something other than an orderly winding up of the company or a restructuring make such expedition very difficult to achieve. The bankruptcy of Sidanko's key subsidiaries was itself the consequence of artificially low transfer prices that they charged the parent company in order to avoid local taxes and, no doubt, generate huge profits

for the principals of favored trading companies. In a sense, Sidanko precipitated some of its own problems. Some creditors have been preferred over others. Tyumen's purchase of the assets of Chernogorneft and Kond-petroleum in any country but Russia would constitute a fraudulent conveyance. The outside interference of Tyumen considerably damages the position of a western equity holder, BP Amoco, in this highly charged political affair. Surely the politically charged atmosphere of this proceeding, the vulture-like behavior of Tyumen, and discrimination against western interests by Russian courts and governments—are not conducive to encouraging more western investment—even though things appear to have reached a state of equilibrium.

2. Example: the Matter of the Lomonosov Porcelain Factory

When the Lomonosov Porcelain Factory was privatized, the managers and workers took its shares. The firm paid its workers with the products that they, the workers, had made. The products were objects made from Lomonosov porcelain for which there is substantial demand in the West. The firm should have been profitable enough to pay wages in money. Apparently, the Factory's managers sold its output cheaply to middlemen, i.e., "trading companies," who in turn resold it at hefty profits. The profits were then diverted, at least in part, to the factory's managers. In *this* case, a worker-shareholder did agitate among his fellow worker-shareholders, but they were not sympathetic. The worker-shareholder left the company and was eventually able to sell his shares to a Russian brokerage which soon was able to purchase more shares from other workers. The Russian brokerage in turn sold the shares at a substantial profit to investors, including the USA-Russia Fund. The Fund learned of management theft from the company and filed a complaint with Russian prosecutors. Management responded by seeking re-nationalization on the grounds that its *own* takeover of the company had not been lawful.³⁷⁵ The Nevsky Regional Civil Court ruled the Westerners' takeover of the board of directors was legal,³⁷⁶ but the St. Petersburg Arbitration Court ruled in a dispute between the State Property Ministry and Lomonosov in October 1999 that the privatization of Lomonosov was not legal.³⁷⁷ In March 2000, the Northwestern Regional Arbitration Court reversed the decision of the St. Petersburg Arbitration

³⁷⁵ These events are described at Richard C. Paddock, *Lomonosov Ruling Frightens Investors*, MOSCOW TIMES, Dec. 14, 1999, available at LEXIS, News Library, Mostms File.

³⁷⁶ See Kristina Shevory, *Court Rules in Favor of New Lomonosov Board*, MOSCOW TIMES, Feb. 9, 2000, available at LEXIS, News Library, Mostms File.

³⁷⁷ See Andrew McChesney, *Investor Fights Porcelain Verdict*, MOSCOW TIMES, Oct. 13, 1999, available at LEXIS, News Library, Mostms File. Hopefully there will be no offensive collateral estoppel without mutuality.

Court, although representatives of the Factory's former administration vowed to appeal.³⁷⁸

These events demonstrate the apparent ineffectiveness of what should be a Russian counterpart to a shareholder derivative action. Shareholder complacency, particularly worker-shareholder complacency,³⁷⁹ is no doubt partly the result of a legal system that does not protect shareholder rights;³⁸⁰ here was a case where a shareholder actually did seek accountability of management for profits, mismanagement, etc. The case presents a test of whether legal rules that protect shareholders' rights actually work. The results are not entirely reassuring.

3. Comment

These two matters, Sidanko and Lomonosov, illustrate several points. First, Russia may eventually "get it right." Eventually BP Amoco obtained what hopefully is a satisfactory resolution of the Sidanko bankruptcy proceeding. Eventually, corrupt Lomonosov management lost control of the profitable corporation in what was essentially a takeover. But too often an appellate court must be called upon to set things right. Moreover, local courts do not learn from reversals because they in fact favor one side over the other. The scare that the Russians throw into western interests is more than what most western investors are willing to tolerate, especially when there are superior investment alternatives. The outcomes in these two matters were obtained only after some explicit and implicit threats, the consequences of which the Russians would regard as worse than the alternatives. BP Amoco threatened to leave Russia altogether. BP Amoco has written off much of its investment already, so its cost of exit has already been re-

³⁷⁸ See Kristina Shevory, *Lomonosov Ruling Favors Investors*, MOSCOW TIMES, Mar. 3, 2000, available at LEXIS, News Library, Mostms File.

³⁷⁹ Employers and mid-level managers are now the dominant block-holders in Russia. Ironically, it is these insiders who have put up the biggest barriers to shareholders' rights. Most Russian trade unions and employee groups have been embarrassing failures as representatives and have not attempted to find independent outside board members with business training to represent their members' shareholdings. At the same time, managers have worked ardently and successfully to block attempts by employee shareholders to exercise their rights. Employees can be fired for selling their shares to an outsider or for attempting to institute cumulative voting to elect independent board representatives. Despite the fact that Russia now leads the world in employee shareholding, the country that so recently called itself the "workers' state" does not legally protect workers' shareholder rights.

BLASI, KROUMOVA & KRUSE, *supra* note 6, at 152.

³⁸⁰ See Baev, *supra* note 31, at 232 (noting inadequate disclosure and anti-fraud protection for investors); Neela Benerjee, *Will Minority Shareholders at UES Be Next?*, MOSCOW TIMES, Feb. 15, 2000, available at LEXIS, News Library, Mostms File (describing abuses of shareholders and questioning recent execution of a merger of a Unified Energy Systems (UES) (run by Anatoly Chubais) subsidiary with an aluminum conglomerate); *Russian Shares: Hot Shares Bothered Investors*, ECONOMIST, July 24, 1999, at 64 (describing abuses of shareholders that include failure to inform shareholders of important matters, dilution, dividend delays, diversion of cash, and asset-stripping).

duced. With regard to Lomonosov, Russian courts' treatment of the westerners' board of directors who accomplished exactly what should be accomplished in a market economy—bad management is ousted by new shareholders who value new management more than the old—is likely to affect western investors' behavior towards Russia for years to come.³⁸¹

Second, and related to the first point, western investors may or not be risk averse—but they want risk that they understand.³⁸² Great risk should hold the promise of great payoffs. Even when a risk should be relatively low, e.g., the Lomonosov firm should be profitable without significant risk—indeed it was profitable to workers despite egregious mismanagement—Russians seem able to create unforeseeable risks. Acknowledging these risks may simply be one part of a steep learning curve. For example, in American bankruptcy law and procedure, there is little to be gained by becoming a creditor, especially after initiation of the bankruptcy proceeding, simply to have a seat at the creditors' table. Yet Tyumen proved that this can indeed be attractive and profitable. Thus Russian bankruptcy may function—inappropriately in the minds of most westerners—as a means of effectuating a corporate takeover.³⁸³ This would hardly be the first time in world history that bankruptcy laws served a purpose other than those purposes for which they were intended. Numerous solvent debtors have used the American bankruptcy laws in order to take advantage of the automatic stay on creditors' claims upon filing a petition in bankruptcy. A cynic might argue that this is simply part of the learning curve for western investors, i.e., that Russian bankruptcy laws should be treated as part of the corporation code, not merely as a law governing insolvency. But most western investors would conclude that the risk of Russian lawlessness or Russian abuse of law is simply a risk that cannot be quantified. If not quantifiable even in a comparative sense against other investment risks, the easiest thing for western investors to do is to walk away and invest elsewhere.

Third, Russian attitudes towards western investors is still highly politically charged. There is fear about losing control to western interests. Russians are hardly alone in this sentiment, but the Russians take it to the point

³⁸¹ See Lee S. Wolosky, *Putin's Plutocrat Problem*, 79 FOREIGN AFF. 18, 24 (March-April 2000) ("Investor fear has a ripple effect ... Widely publicized misconduct involving Russia's largest companies and most prominent business leaders scares away international investors from all Russian companies – including those with no intention of defrauding anyone").

³⁸² Cf. Black & Kraakman, *supra* note 342, at 1922-23 (ownership structure of many corporations present clear risk of opportunism towards outside shareholders; investors discount value of shares so much that equity markets virtually paralyzed; investors may similarly over-react to corporate scandals).

³⁸³ See Igor Semenenko, *Crystal Firm to Appeal Ruling*, MOSCOW TIMES, Aug. 30, 2000, available at LEXIS, News Library, Mostms File (accusation of takeover effort in bankruptcy proceeding of Gusevsky Crystal Factory); Tavernese, *supra* note 228 (detailing case of Novokuznetsk Aluminum).

of making their industries unattractive as investments.³⁸⁴ As a result, in "recent years Russia has received less direct investment than has Peru."³⁸⁵

Fourth, the Russian economy is likely to grow outside of and despite the legal and political systems. The erratic performance of the Russian court system causes western investors to avoid it. Western investors naturally prefer dispute resolution to occur through arbitration outside of Russia. Russian economic interests will develop to the extent that government interests stop intervening in the economy. This in fact is the pattern of development in most countries. The market economy develops first, and the political system develops to serve that economy. This process can take hundreds of years. As already noted, the Russians are "trying to do everything at once." Even so, development of the economy will occur first. The time frame is compressed compared to that of western nations, but hopefully the task is not too formidable when there is an understanding of just what that task is.

There are signs of a market economy emerging from the "bottom up." Solutions to problems are indeed emerging—slowly—from outside government and from outside the old system that did not work. For example, the credit necessary for such an emergence might come from small companies themselves as industry invests in itself. Customers invest in suppliers. Eventually Russia will need a healthy banking system, but such ingenuity buys time.³⁸⁶

A move to break the downward spiral of a barter economy is the creation of a market in *veksels*, or IOUs. Investors in fact have begun to speculate in *veksels*.³⁸⁷ Such speculation may be the first step towards the emergence of a junk bond market. An orderly bond market would, at least for those firms finally sound enough to take advantage of it, reduce the enormous transaction costs associated with a barter economy. Firms able to issue bonds would have a source of cash with which to carry on their businesses. The Association of Members of the Veksel Market ("AUVER," or "Association"), a group of banks and brokerages, hopes to create an orderly market in *veksels*, a market whose daily turnover is ten times that of the stock market.³⁸⁸ The Association hopes to make the market more transpar-

³⁸⁴ The South African diamond firm, De Beers, recently abandoned its \$100 million investment in the Russian diamond market without much hope of recouping its investment. Vitaly Basygov, deputy head of the Duma's natural resources committee, said, "The diamond industry is one of the most successful in the national economy, so there is no need to give the best sites to foreign companies." This type of thinking implies that only the most undesirable enterprises should be available to western investors. See Semenenko, *supra* note 180.

³⁸⁵ See Wolosky, *supra* note 381, at 24.

³⁸⁶ See Higgins, *supra* note 83 (citing examples of juice company loaning money to farm, and pulp and paper company loaning money to logging company).

³⁸⁷ See Andrews, *supra* note 97 (describes emergence of investment market for *veksels*).

³⁸⁸ See Andrew McChesney, *FSC Grabs IOU Bull by Horns*, MOSCOW TIMES, Jan. 19, 2000, available at LEXIS, News Library, Mostms File (*veksel* market valued at \$21 billion).

ent and thereby encourage more investment from the West because various risks associated with investing in nontransparent investment vehicles would be eliminated.³⁸⁹

VII. CONCLUSIONS AND FINAL COMMENTS

Now is the best time in many years for meaningful legal and market reform of the sort herein described to occur. There are reasons to be optimistic. In the first year of the new bankruptcy act's existence, bankruptcy filings increased five-fold.³⁹⁰ Even some prominent firms have been caught up in this.³⁹¹ Other firms are restructuring.³⁹² The world price of oil has doubled and even tripled since 1998; this has brought more than \$1 billion/month into the Russian economy.³⁹³ The Russian government is collecting taxes.³⁹⁴ Taxes collected from oil and gas companies plus the collection of a relatively recently imposed tariff on oil exports have increased government revenues significantly; fuel and energy provide 20% of the federal budget's revenues and 40% of the nation's hard currency.³⁹⁵ Moreover, the ruble has taken such a pounding that efficient domestic firms

³⁸⁹ See Andrew McChesney, *Veksel Trade Rules Set to Lure Investors*, MOSCOW TIMES, Jan. 22, 2000, available at LEXIS, News Library, Mostms File (describing formation, purpose, and goals of AUVER).

³⁹⁰ See *More Bankruptcy Cases Reported in Russia*, RUSS. AND COMMONWEALTH BUS. L. REP., Apr. 21, 1999, available at LEXIS, News Library, RCBLR File.

³⁹¹ See Catherine Belton, *Court Declares Menatep Bankrupt*, MOSCOW TIMES, Sept. 30, 1999, available at LEXIS, News Library, Mostms File (discussing "former banking powerhouse Menatep[,] one of [Russia's] major oligarchic institution"); *Inkombank Declared Bankrupt*, MOSCOW TIMES, Feb. 3, 2000, available at LEXIS, News Library, Mostms File (Inkombank).

³⁹² See Jason Bush, *Russia's New Dawn*, BUS. CENT. EUR. (March-April 2000), available at <http://www.bcemag.com/y2000/mar00/cover/0003cover.htm> (Sibneft Oil Company, Vimpelcom Mobile Phone Company, Siberian Aluminum, and Yaroslavl Tyre Plant); Igor Semenenko, *Glass Industry Recast to Make Profit*, MOSCOW TIMES, Mar. 15, 2000, available at LEXIS, News Library, Mostms File (Gus-Khrustalny glass and crystal factory); Anna Shcherbakova, *Machine-Building Giant Draws Up Survival Plan*, MOSCOW TIMES, Oct. 9, 1999, available at LEXIS, News Library, Mostms File ("machine-building giant Izhorskiye Works").

³⁹³ See Yevgenia Borisova, *Oil at \$25 Brings in Massive Windfall*, MOSCOW TIMES, Nov. 17, 1999, available at LEXIS, News Library, Mostms File; Valeria Korchagina, *Firming Oil Prices Boon for Budget*, MOSCOW TIMES, May 5, 2000, available at LEXIS, News Library, Mostms File.

³⁹⁴ See Associated Press, *In Brief*, MOSCOW TIMES, May 4, 2000, available at LEXIS, News Library, Mostms File (budget surplus of \$850 million for first four months of 2000); see also Yevgenia Borisova, *Minister: Tax Take Should Stabilize at 9% of GDP*, MOSCOW TIMES, Jan. 15, 2000, available at LEXIS, News Library, Mostms File (collections have exceeded targets, targets have increased, and a higher percentage of taxes due are actually collected).

³⁹⁵ See Borisova, *supra* note 393 (unfortunately the war in Chechnya is devouring much of the windfall).

are able to produce goods profitably³⁹⁶ because Russian consumers simply can no longer afford as many foreign goods. This is an opportune time to make the bankruptcy laws work so that Russia's most efficient firms actually prosper rather than drown in a sea of more efficient foreign competitors. Thus, Russia's financial collapse may turn out to be a "blessing in disguise," at least for those in the real economy.³⁹⁷ Of course restructuring must be real.³⁹⁸

An import-substitution recovery that generates glowing economic numbers, but without real reform eventually amounts to nothing. Such a "recovery" relies on what economists refer to as "inferior goods," i.e., goods for which demand increases as consumer income decreases. Certainly Russia should not count on world oil prices to remain artificially high. Nor is a currency that steadily declines in value, thereby improving the outlook for domestic producers and exporters, the basis upon which a strong economy is built. The IMF notably has begun to insist on evidence of real change in Russia before extending more loans, even at a time when economic indicators have turned upward.³⁹⁹ The IMF delayed release of a \$640 million tranche in late 1999. Alexander Livshits explained: "The IMF tranche is not only money...it is a tranche of trust."⁴⁰⁰ A sobering indication that economic reform is not real is the increase in capital flight that has occurred when times got better.⁴⁰¹ The oil windfall presents an opportunity to hasten the move towards a market economy and to pay international and domestic debts. Focus is required lest oil revenues become simply the means of fa-

³⁹⁶ See *IMF Says Reforms Key to Recovery*, MOSCOW TIMES, Sept. 24, 1999, available at LEXIS, News Library, Mostms File, quoting Michael Mussa ("There has been a surge in output behind the protection of a depreciated exchanged rate").

³⁹⁷ See Killen, *supra* note 71.

³⁹⁸ See *Russia: Sweetly Flows the Volga*, ECONOMIST, June 5, 1999, at 62 (citing success of Nestle and Avtovaz in Samara and noting failure of most companies to take advantage of situation; sales to the bankrupt sector and management theft from companies continue); see also Arnold, *supra* note 20 (devaluation helps cushion blow of crisis, but increased domestic sales "only prolong the delusion that Russian manufacturers are viable without reform").

³⁹⁹ See Catherine Belton, *IMF Questions Will to Reform*, MOSCOW TIMES, May 16, 2000, available at LEXIS, News Library, Mostms File (key changes include tax reform, reduction of industry subsidization by regional governments, strengthening the social safety net, eradication of non-payments, and restructuring industries that survive on subsidies).

⁴⁰⁰ Celestine Bohlen, *Russia Stuck in IMF's Bad Books*, MOSCOW TIMES, Nov. 9, 1999, available at LEXIS, News Library, Mostms File (noting improvements in GDP, tax revenues paid in cash, paid-up pensions, trade surplus).

⁴⁰¹ See Catherine Belton, *\$2.9 Bln a Month Flows Out of Russia*, MOSCOW TIMES, Nov. 23, 1999, available at LEXIS, News Library, Mostms File ("it would be difficult to stop the damaging outflow without root and branch restructuring of the Russian economy").

The World Bank has expressed concern over the slow progress in reform of the corporate and financial sectors – as well as continued capital flight. See Igor Semenenko, *Bank: Growth Rate to Dry Up*, MOSCOW TIMES, April 12, 2000, available at LEXIS, News Library, Mostms File (reporting on World Bank's "Global Development Finance 2000" in which World Bank predicts a *slowing* of economic growth in Russia and surrounding region).

cilitating war in Chechnya, electing particular politicians, and dispensing political favors to particular businesses.⁴⁰² It is the most opportune time that there will ever be to use the bankruptcy law aggressively so that the rewards of efficiency are clear and the cost of inefficiency and failure to restructure is exit that is both unavoidable and highly visible. But the opportunity will not last long; indeed, the opportunity for meaningful restructuring may already be passing.⁴⁰³ Exports, largely of raw materials, have increased because of the weak ruble, but the rate of increase is slowing. Russian consumers simply do not possess sufficient wealth to sustain the growth, and Russian manufactured products lack the quality necessary to compete in the export market. There are signs that the ruble, which fell from roughly 6 to the dollar to 25 to the dollar in August 1998, is weakening again.⁴⁰⁴

On December 31, 1999, Boris Yeltsin announced his resignation from the presidency of Russia and appointed Vladimir Putin interim president. Mr. Putin handily won the election of March 26, 2000. There are encouraging signs, both that Mr. Putin recognizes the problems identified herein with the Russian economy and that he is willing to address such problems forcefully.⁴⁰⁵ Of course caution is required whenever evaluating any promises of Russian leaders concerning future handling of the Russian economy. Mr. Putin was a KGB agent who served in East Germany. He appears to be focused on ends without necessarily caring about means,⁴⁰⁶ i.e., the balance between individual freedoms and public order.⁴⁰⁷ Russia has rarely, if ever,⁴⁰⁸ had what citizens of other countries would regard as an acceptable level of personal freedoms. But some of President Putin's initiatives deserve comment.

⁴⁰² See Yevgeny Borisova, *Putin Hits Political Jackpot In Oil Boom*, MOSCOW TIMES, Nov. 18, 1999, available at LEXIS, News Library, Mostms File (speculating that top priorities are Chechnya and elections; unpaid wages become top priority only when people block railways).

⁴⁰³ See Catherine Belton, *Lessons of Aug. 17 Crash Not Learned*, MOSCOW TIMES, Aug. 17, 2000, available at LEXIS, News Library, Mostms File (noting especially the failure to restructure Russian banks); Michael Wines, *Factory's Turnaround Reflects a Glimmer in Russia's Economy*, N.Y. TIMES, June 2, 2000, at A1.

⁴⁰⁴ See Julia Tolkacheva, *Central Bank Steps In to Support Ruble*, MOSCOW TIMES, Aug. 31, 2000, available at LEXIS, News Library, Mostms File.

⁴⁰⁵ See Yevgenia Albats, *Power Play: Reform Military to Cure Nation's Cancer*, MOSCOW TIMES, Aug. 31, 2000, available at LEXIS, News Library, Mostms File (Putin "the first Russian leader to publicly acknowledge the disastrous state of the country").

⁴⁰⁶ "We have a fighter who has come to power and whose nature is not to play, but to win. He not only is motivated to succeed, he is maniacally motivated to succeed." Patrick E. Tyler, *Russians Wonder if Putin Accepts Limits to Power*, N.Y. TIMES, Aug. 14, 2000, at A1 (quoting Professor Aleksandr B. Asmolov, psychologist at Moscow State University).

⁴⁰⁷ See Tyler, *supra* note 406 (quoting Aleksandr I. Gelman).

⁴⁰⁸ Perhaps from February 1917 to October 1917.

First, Mr. Putin recognizes the unruliness of Russia's 89 provincial governors, many of whom have openly defied federal laws. Mr. Putin is endeavoring to relocate the locus of economic authority towards the Kremlin. He has divided the country into seven federal districts, each with a presidential representative who in turn has representatives or deputies in the larger cities.⁴⁰⁹ The new representatives report directly to the president. Clearly this move is designed to weaken the authority of the provincial governors. Previously, President Yeltsin had personal envoys to each of the 89 provinces. Unfortunately these envoys received benefits (e.g., salary, office space, jobs for family members, summer camps for their children) and some salary from local governments—which essentially led to their co-option. Repeated restructurings that occur with every new leader are a familiar feature of Russian history—as is the co-option of the national representatives by the local authorities. The new representatives receive their salary and budget from the Kremlin. Recognition that a federalist system is out of balance does not mean that balance is easily restored. Provincial governors have professed enthusiasm for the plan—an indication that they might not feel particularly threatened by a plan that is aimed directly at their powers. Mr. Putin and his representatives must still gain and exercise sufficient power and earn sufficient respect for this system in order to bring the unlawfulness of local governors under control. This may include the power to terminate regional governors who flout federal law or the Constitution. Moreover, removal of the governors from the Federation Council so that such governors as a group cannot exercise even a negative power of veto over federal legislation may be necessary. Such removal might require amending Article 95 of the Russian Constitution. When the matter has come up for a vote, the Duma (lower house) has strongly endorsed legislation to strip governors of their seat in the Federation Council; unsurprisingly, the Federation Council has resisted, but the Duma has sufficient votes to overcome the veto.

Second, President Putin established a think tank, the Center for Strategic Planning. In early 2000, the Center produced a plan for the Russian economy,⁴¹⁰ whose policy thrust is the creation of “conditions for the

⁴⁰⁹ This developing story is described at, in chronological order: Michael Wines, *Putin Decrees New Controls and Envoys for Provinces*, N.Y. TIMES, May 14, 2000, at A9; Sarah Karush, *Putin Carves Country Into 7 Districts*, MOSCOW TIMES, May 16, 2000, available at LEXIS, News Library, Mostms File; Michael Wines, *Putin's Move on Governors Would Bolster His Role*, N.Y. TIMES, May 22, 2000, at A3; Maura Reynolds, *Putin Address Details Nation's Woes*, MOSCOW TIMES, July 11, 2000, available at LEXIS, News Library, Mostms File (coverage of President Putin's state of the union address of July 8, 2000); Tyler, *supra* note 406; *The Bridling of Russia's Regions*, ECONOMIST Nov. 11, 2000, available at 2000 WL 8144332.

⁴¹⁰ This story is described at, in chronological order: Catherine Belton, *Plan for the Economy*, MOSCOW TIMES, May 23, 2000, available at LEXIS, News Library, Mostms;

emergence of the effective private sector."⁴¹¹ The features of the plan are the following:

- Reducing taxes by introducing a flat 13% income tax, eliminating the turnover tax, reducing payroll payments to social funds to 35%, and allowing deductions for business-related expenses;
- Reducing state spending to 30% of GDP. Payments for social needs will not decrease, but their percentage of GDP will decrease as the economy and the tax base grow;
- Reducing or eliminating state subsidies to businesses, especially non-cash subsidies such as low energy tariffs, and providing temporary unemployment benefits for laid off workers and funds to local authorities in company towns for maintenance of kindergartens, schools, and hospitals that were previously funded by non-viable firms;
- Eliminating social subsidies that the government never funds and eliminating housing subsidies;
- Privatizing management, maintenance, and utilities related to housing;
- Reallocating expenditures on subsidies to health, education, and defense;
- Separating the state from commercial interests, especially with respect to the Railroad Ministry, Gazprom, and Unified Energy Systems;
- Privatizing more state-owned enterprises, including all profitable coal mines, and creating joint stock companies of most of the remaining state-owned enterprises with the state retaining an interest;
- Eliminating price fixing agreements between natural monopoly cartels and sales services;
- Requiring businesses to adopt international accounting standards;
- Equalizing taxes on banks and corporations by lowering the profit tax on banks thereby decreasing the disincentive of banks to conceal profits;
- Requiring the Central Bank to phase out its holding of financial stakes in commercial banks at home and abroad;
- Allowing the Central Bank to draw up restructuring plans for the financial sector;
- Regulating off-shore operations in order to reduce capital flight;
- Improving the court system in order to protect investors' and citizens' rights;
- Simplifying the registration of businesses;
- Introducing clearly understood limitations of authority for local officials in order to reduce arbitrary bureaucratic action;

Aron, *supra* note 13; Michael Wines, *Russia Unveils a Bold Economic Blueprint*, N.Y. TIMES, June 29, 2000, at A6.

⁴¹¹ Aron, *supra* note 13 (quoting report).

- Establishing a market for the free sale of land, thereby hopefully inducing investment in mortgages and the construction of much needed housing;
- Making the pension age 65 for both men and women and introducing accumulative pension accounts funded by tax-deductible contributions up to a specified limit;
- Increasing the salaries of officials, including substantial increases for judges, in order to reduce the incentive to engage in corrupt practices—coupled with a substantial decrease in the number of state workers.

Implementation of all of these measures would certainly change the social contract, i.e., the Russian notion of entitlements, from the one described earlier in this paper. The plan envisions that market competition will be the “key regulator of economic development,”⁴¹² not the state—a truly remarkable transformation should it actually come to fruition. The state is to become the servant of society.

Because the plan would be so dramatic in its impact, there is reason to be concerned about its realization—even in part. As an initial matter, Mr. Putin must of course sign on. In his state of the union address of July 8, 2000, President Putin expressed strong support for the plan’s substance⁴¹³ and is preparing legislation to implement various aspects of the plan.⁴¹⁴ Moreover, the Duma appears to be signing on rather than succumbing to the opposition of the Communists, trade unionists, and regional administrators,⁴¹⁵ although opposition to significant reforms has certainly not disappeared.⁴¹⁶

Third, Mr. Putin evidently has undertaken to do something about the oligarchs.⁴¹⁷ Measures have included filing tax evasion charges, demands

⁴¹² *Id.*

⁴¹³ See Brian Killen, *Putin Says Economy Soft, Growth Fragile*, MOSCOW TIMES, July 11, 2000, available at LEXIS, News Library, Mostms File (reporting on speech); Reynolds, *supra* note 409.

⁴¹⁴ See Tyler, *supra* note 406 (legislation to reform customs laws, the legal system, and law enforcement agencies).

⁴¹⁵ In chronological order, see Wines, *supra* note 410, at A6; Peter Graff, *Duma Bows to President Over Social Funds*, MOSCOW TIMES, June 10, 2000, available at LEXIS, News Library, Mostms File (Duma approving unification and reduction of various social taxes); Igor Semenenko, *Key Pension Changes Mulled*, MOSCOW TIMES, Sept. 2, 2000, available at LEXIS, News Library, Mostms File (Duma turning its attention to various plans to reform Russian pensions).

⁴¹⁶ See Aron, *supra* note 13 (identifying state-owned monopolies, directors of subsidized and tax-exempt enterprises, bureaucrats who supplement their incomes through taxation, communist-affiliated trade unions, workers at unprofitable enterprises, those who will lose housing subsidies – as sources of opposition).

⁴¹⁷ This paragraph is drawn from, in chronological order: Michael Wines, *Russian Puzzle: What Does War on Tycoons Mean?*, N.Y. TIMES, July 15, 2000, at A3; *Putin Gets a Grip*, ECONOMIST, Aug. 5, 2000, at 47-48; Igor Semenenko, *Oligarchs Feeling Kremlin Squeeze*, MOSCOW TIMES, Aug. 8, 2000, available at LEXIS, News Library, Mostms File.

that they pay money that they allegedly shorted the government in acquiring their properties, raids on and searches of offices, and an occasional arrest (followed shortly by a release). As mentioned earlier, the oligarchs' control of wealth does not affect the amount of wealth in Russia, but it obviously is one particular distribution of that wealth. There is little reason to favor this particular distribution rather than just about any other. The loan-for-shares program assured that the government itself would be far more destitute than necessary—to say nothing of the many who were denied any opportunity to bid on the choice properties that were distributed in that program. Mr. Putin's government does not appear to be able or willing to destroy any of the oligarchs, but it does seem quite interested in enforcing rules that require the oligarchs to pay their fair share of taxes. For some who have become accustomed to tax evasion and government favors, this may seem like an attack or a crackdown. To the extent the government is successful, moves against the oligarchs are politically very popular. So long as the government moves against oligarchs only to get *them* to disgorge ill-gotten gains, there is little reason to complain. But it would be counter-productive to sweep outside investors up in a crusade of confiscation against thieves.

In late summer and early fall 2000, three tragedies befell Russia. Terrorists bombed a Metro station in Moscow, the Kursk submarine sank killing 118 sailors, and a fire on the Ostankino television tower took still more lives. The tragedies in a sense demonstrate how rotted Russia's infrastructure has become. These are highly visible events. There are others. Russia cannot feed its diminishing population. The war in Chechnya drags on. Bombs go off in other cities, often in crowded marketplaces. President Putin's style is clearly authoritarian. There is, nevertheless, a brink that Putin cannot pass over. He learned this in his handling of the Kursk affair, i.e., the public outcry to his not interrupting his Crimean vacation while Russian rescue efforts proved clumsy and ineffective. The fact that there was such an outcry is an indication that Russian citizens may demand both more responsive government and more competent government.⁴¹⁸ Top-down implementation of necessary reforms remains the appropriate course.⁴¹⁹ Alexander Kerensky's Provisional Government tried to imple-

⁴¹⁸ See *Putin's Sea of Troubles*, *ECONOMIST*, Aug. 26, 2000, at 13 ("loss of the *Kursk*, and the bungling that followed ... may yet make Russians think about the sort of government they deserve").

⁴¹⁹ Putin has it right, for the defining feature of Russian developments for the past decade or more has not been progress or setbacks on the path of reform, the focus of so much Western commentary, but the fragmentation, degeneration, and erosion of state power. During that time, a fragile Russian state of uncertain legitimacy has grown even weaker as a consequence of deliberate, if misguided, policies, bitter and debilitating struggles for political power, and simple theft of state assets. The erosion of the state has reached such depths that the central state apparatus, or the center, as it is commonly called in Russia, has little remaining capacity to mobilize resources for national purposes, either at home or abroad, while most regional and local governments lack the resources – and in some cases the desire – to govern effectively. The obvious weakness of the state has, not sur-

ment reforms from the bottom up in 1917,⁴²⁰ and the result was a 75-year odyssey of economic disaster. But implementation of reforms must be even-handed and responsive. That mean de-politicizing business and forcing insolvent firms into bankruptcy.

prisingly, fueled fears about Russia's stability, integrity, and for some Russians, its survival.

THOMAS E. GRAHAM, JR., *The Fate of the Russian State*, 8 DEMOKRATIZATSIYA 354, 354 (2000).

⁴²⁰ See B.H. SUMNER, A SHORT HISTORY OF RUSSIA 361 (1949):

The Revolution of March 1917, in the midst of war, opened the sluice-gates of liberty: freedom to say and write anything and everything, to form committees on anything and everything, to work or not to work; soon also freedom to take the land, take the factories, go home, stop fighting. This new, intoxicating liberty became anarchy; authority was more and more repudiated unless it claimed to be exercised in the name of the "workers, peasants, soldiers and sailors," and frequently even when it did so claim.

See also BERNARD PARES, A HISTORY OF RUSSIA 490 (Definitive Ed. 1953) (initiative for revolution was crowds on the streets; right to direct the country disputed).