

**PRIVATIZATION IN RUSSIA:
BACKGROUND, CURRENT PROSPECTS, AND RISKS**

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September 17, 1997

TABLE OF CONTENTS

I.	INTRODUCTION	1
II.	BACKGROUND: MASS PRIVATIZATION IN RUSSIA	1
III.	PRIMARY METHODS OF PRIVATIZATION	8
	A. STRAIGHT AUCTION	9
	B. SPECIAL AUCTION	9
	C. COMMERCIAL TENDER	10
	D. DEBT-EQUITY SWAPS	12
IV.	PRIVATIZATIONS SCHEDULED FOR 1997-1998	12
	A. MAJOR ENTERPRISES	14
	1. Tyumen Oil Company	14
	2. Rosneft	15
	3. Slavneft	16
	4. United Energy Systems	17
	5. Sviazinvest	17
	6. Roslesprom	18
	7. Rosgorstrakh	18
	8. Russian Electronics	19
	B. PARTIALLY PRIVATIZED ENTERPRISES IN STRATEGIC INDUSTRY SECTORS	19
	C. DEFENSE ENTERPRISES	20
	D. PRIVATIZATION THROUGH INSOLVENCY	21
	E. PRIVATIZATION BY INDIVIDUAL PROJECT	22
V.	RESTRICTIONS ON PARTICIPATION BY FOREIGN INVESTORS	23
VI.	LEGAL RISKS CONNECTED WITH PRIVATIZATION	24
VII.	CONCLUSION	29

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TABLE OF CONTENTS

- I. Introduction**
- II. Background: Mass Privatization in Russia**
- III. Primary Methods of Privatization**
 - A. Straight Auction
 - B. Special Auction
 - C. Commercial Tender
 - D. Debt-Equity Swaps
- IV. Privatizations Scheduled for 1997-1998**
 - A. Major Enterprises
 - 1. Tyumen Oil Company
 - 2. Rosneft
 - 3. Slavneft
 - 4. United Energy Systems
 - 5. Sviazinvest
 - 6. Roslesprom
 - 7. Rosgorstrakh
 - 8. Russian Electronics
 - B. Partially Privatized Enterprises in Strategic Industry Sectors
 - C. Defense Enterprises
 - D. Privatization through Insolvency
 - E. Privatization by Individual Project
- V. Restrictions on Participation by Foreign Investors**
- VI. Legal Risks connected with Privatization**
- VII. Conclusion**

I. INTRODUCTION¹

Privatization in Russia has attracted only the bravest of foreign investors. This is understandable in light of the political controversy and legal chaos that mass privatization has produced in Russia since it began in 1992. However, anyone interested or involved in investment in Russia needs to understand privatization there, for two primary reasons. First, the chance to invest profitably through privatization cannot responsibly be dismissed out of hand. Second, the new private economy is permeated with the consequences of privatization. Thus, for example, familiarity with privatization will help to understand how one's business counterparts came to own their company, and anyone seeking to invest in a formerly state-owned company will need to understand how the privatization occurred in order to examine risks arising from the privatization.

II. BACKGROUND: MASS PRIVATIZATION IN RUSSIA

Between 1992 and 1996, approximately 127,000 formerly state-owned enterprises in Russia underwent full or partial privatization. This accounts for over 77% of all mid-sized enterprises (those with over 200 employees) and large enterprises (with over 1,000 employees), and over 82% of all small shops and retail stores. As a result, approximately half of the Russian work force is

¹ Thanks to Vasilisa Strizh, associate at McDermott, Will & Emery, for her indispensable help in preparing this article, and to Vladislav Zabrodin, of counsel to McDermott, Will & Emery, for assistance in research for this article.

now employed in the private sector. This privatization effort has been larger and faster than any other in the history of any country.²

The following presentation focuses on the privatization of the medium-sized and large enterprises, because these are the industrial enterprises that are of most interest to foreign investors. Privatization of farms is not addressed here, because privatization in that sector is much lower on the political agenda and has gone much more slowly than industrial privatization. Major land acquisitions will not present significant opportunities to foreign investors for the foreseeable future. Similarly, privatization of the retail sector is also not addressed, except to say that it is almost finished and has been practically closed to outside investors.

A brief description of the results until now of industrial privatization is necessary, because in most cases outside investors seeking to buy significant stakes in Russian companies through privatization will not be the first private shareholders in such companies. Rather, in most cases outside investors will be joining other private shareholders by buying out the government's shareholding, often a minority stake, in such companies. Therefore, for such new investors, the structure of existing private ownership in such companies, which is the result of the privatization process to date, will often be of critical importance in evaluating the attractiveness of an investment.

² Blasi, Kroumova, and Kruse, *Kremlin Capitalism: The Privatization of the Russian Economy*, pp. 25-26 (Cornell, 1997); *Ekonomika i Zhizn*, No. 29 (1997)

When the Russian mass privatization legislation was being drafted and debated in 1992, two primary questions were at issue. The first was whether to privatize at such a fast pace and large scale as the government wanted. This question is of great historical, political, and economic significance, but it need not occupy us in detail here, and is touched on briefly later in the general assessment of the success of Russian privatization.³ The second major question was framed in two ways in the political rhetoric of that time: (a) who are the rightful owners of Russia's industrial wealth, and (b) what is the best procedure to ensure that companies would go to the most economically effective owners and managers. Many savvy people, especially those employed in the industrial sector, understood that whatever the rhetoric, privatization was a battle for corporate control in what would inevitably be a rapid privatization process.

The debate at that time produced two camps: (1) an industrial lobby which argued that the management and workers of each company (hereafter "employees," in the parlance of the legislation) were both rightful and effective owners, and (2) the proponents of voucher privatization, who argued that all citizens should have an equal share in the total industrial wealth, and that selling companies to the highest bidders would put companies in the hands of the most effective owners.

The privatization legislation that was adopted was a compromise between the two views. The medium and large enterprises referred to above were

³ See page 8 below.

"corporatized," i.e., the government converted them to open joint stock companies and issued shares in the new companies. The first block of voting shares -- at least one-third, and sometimes over fifty percent -- were sold to the employees in a closed subscription at book-value prices that were usually many times below the eventual market prices. An additional block of voting shares - - typically 29% to 40%, and in some cases all of the voting shares remaining after the closed subscription -- were sold at public auction for privatization vouchers, bearer instruments that were issued to every citizen.

In many valuable companies, the employees amassed vouchers in order to maximize their acquisition of auctioned shares. Despite the government's efforts to require wide access to voucher auctions, the massive scale and fast pace of the privatization campaign often led to organizational problems that gave the employees informational and procedural advantages over outsiders in voucher auctions. The employees usually succeeded in using the voucher auctions to consolidate their control over the company. In Russia's mid-sized and large privatized corporations, this has led to a degree of insider control without parallel in any other market economy. For example, as of 1996, in over 95% of such companies, insiders held at least 26% of the shares; and in over half of the companies, insiders held stakes of at least 57% of the shares.⁴ This has led to serious problems in corporate governance and in the protection of minority shareholder rights.⁵

⁴ Blasi, et al., p. 194.

⁵ See Blasi, et al., pp. 96-105, 200-202.

From its inception and through its implementation, the Russian privatization program has been a source of political contention, corruption, scandal, and even violence. In August of this year, the top privatization official in St. Petersburg, the head of the local Property Management Committee, was murdered in a contract killing, for reasons rumored to be connected with conflicts over the division of valuable city real property, and another St. Petersburg privatization official was murdered two months earlier.⁶ And in early September, the General Procurator announced that Alfred Kokh, the recently dismissed chairman of the State Property Management Committee, the principal ministry responsible for privatization policy and decision-making, was being investigated in connection with \$100,000 he received from an unknown Swiss company, supposedly as an advance for a book which he has not yet written.

Probably the most vilified phase of the privatization campaign was the "loans for shares" program of late 1995. At that time, the government mortgaged large blocks of shares in a number of the country's most valuable enterprises: for example, 40% and 38% respectively of the shares of two of the top oil companies, Surgutneftegaz and Sidanko; and 38% and 15% respectively of the metals giants Norilsk Nickel and Novolipetsk Metallurgical Combine. In each deal, shares in a particular company were placed in trust with a bank in return for a loan to the government. During the period of the loan -- generally nine to eighteen months -- the trustee had the right to vote these shares. At the end of the loan period, if the government did not repay the loan (which it did not

⁶ The Moscow Times, August 19, 1997, August 20, 1997.

for any of the loans), the trustee had the right to auction the shares and use the proceeds to repay the loan.

The "loans for shares" program has been virtually unanimously criticized as unfair, and the government has never denied this. First, the very structure of the transactions -- loans for shares, and the procedures for auctioning the right to act as trustees, were viewed as rigged in order to favor a few of the major banks in the country. These banks had played a key role, financially and through the media outlets that they controlled, in the reelection of President Yeltsin in the summer of 1995. Second, in holding the follow-up auctions for ownership of the shares, the bank-trustees that managed these auctions were allowed to bid through their affiliated companies. In the last of these auctions, for a 38% equity stake in Norilsk Nickel (which constitutes a 51% voting block after taking into consideration preferred shares) -- the metals giant that accounts for about five percent of the Russian gross national product -- Uneximbank not only ran the auction, and its affiliated company submitted the winning bid, but the only other bid was submitted by a company reportedly controlled by Uneximbank. The second bid was necessary because the auction would not be valid if there were only one bidder.⁷

The auctions for shares of Norilsk Nickel and the telecommunications holding company Sviazinvest (which was not part of the loans for shares program and

⁷ Rossiiskaya Gazeta, July 12, 1997; Kommersant Daily, July 30, 1997, August 9, 1997.

is discussed in Section IV.A.5 below) in July and August of 1997, both won by groups backed by Uneximbank, have led to political conflicts at the highest levels of government. The losing consortium alleged that Uneximbank, which is headed by a former first deputy prime minister, used its government contacts to receive inside information that enabled it to win the bidding. President Yeltsin cited this as the reason for dismissing the chairman of the State Property Committee. Uneximbank has countered that the losing consortium tried to use its government contacts to negotiate a deal that would preempt competitive bidding between the two consortiums. As this article was being completed, the lead stories in the newspapers were about the President's personal intervention to stop the "war" of the top banks over privatization.⁸

The Sviazinvest and Norilsk Nickel auctions were seen by some commentators as evidence that privatization is becoming more open and competitive, because the bidding was closer to perceived market values of the shares than other major privatizations, especially those connected with the loans for shares program. Also, the dispute between two of the country's dominant banking and financial groups over the Sviazinvest auction was considered an encouraging contrast to the loans for shares program, when the assets were divided up without any public disputes between the participants in the program. Even if the recent disputes indicate progress in the government's gaining independence from such groups, any participant in the privatization of Russia's "crown jewel"

⁸ The Moscow Times, July 8, 1997, August 16, 1997, August 20, 1997, September 16, 1997, September 17, 1997; Commersant Daily, September 16, 1997, September 17, 1997.

companies still faces a serious risk that competition will at best be among the groups that enjoy special access to the government.

Having presented the bad news about privatization in Russia, it's appropriate to discuss how bad the news really is. A thorough evaluation of the historical, political, and economic consequences of privatization in Russia is beyond the scope of this paper. My own view, however, is that in light of the collapse of the Soviet economic system in the late 1980s and early 1990s, and the political disintegration of the USSR at the end of 1991, it has been a tremendous accomplishment of Russia to transfer such a huge amount of state property to private ownership, without a civil war or regional fragmentation, with as little violent settling of private scores as there has been, and with the beginnings of a robust market economy and some legal framework, and political order, however imperfect, in place. There is no guarantee that the trend toward economic growth and development of a law-based market economy will necessarily continue, but in my opinion the odds are good, and even much better than at any time since 1991, that events will move in that direction.

III. PRIMARY METHODS OF PRIVATIZATION

In July of 1997, a new basic law on privatization, the Law on Privatization of State Property and on the Fundamentals of Privatization of Municipal Property in the Russian Federation (hereafter the "Law on Privatization"), was adopted. The new law for the most part consolidated and restated the status quo which was previously contained in numerous presidential, governmental, and lower-

level administrative decrees and parliamentary acts that had been adopted piecemeal since 1992. However, the new law also made some important changes in the methods of privatization, as discussed in Section III below.

Under the new Law on Privatization, the primary methods of sale of shares in state-owned companies to outside investors are the following: (1) sale by straight auction; (2) sale by "special" auction; and (3) sale by commercial tender with investment or social conditions. Following is a description of each of these methods.

A. STRAIGHT AUCTION

In a straight auction, a block of shares is sold to the bidder who offers the highest price for the entire block of shares. In such an auction, there are no conditions other than the price.⁹

B. SPECIAL AUCTION

In a special auction,¹⁰ each bidder states the amount of money he is offering and the minimum number of shares he is willing to acquire for such amount of money, from which follows the maximum price he is willing to pay for each share. From these bids, a sale price per share is calculated using an algorithm, and all bidders who offered that price or higher receive at the sale price a

⁹ Law on Privatization, section 22.1.

¹⁰ Special auctions are referred to in the Law on Privatization, section 22.3.

number of shares proportionate to the total amount of money that they offered.¹¹

C. COMMERCIAL TENDER

The new Law on Privatization provides that when the asset being privatized is either over fifty percent of a company's shares, or the entire enterprise itself, the method of privatization must be a commercial tender. In a commercial tender, bidders are required to commit to follow an investment program and/or fulfill "social conditions" such as keeping the work force at a certain level; retraining employees; maintaining social services provided by the enterprise to its employees or, in the case of company towns, to the general population; and even using domestic materials. The winner of such a tender is the bidder who promises to fulfill the investment or social conditions and offers the highest purchase price.

The winner of a commercial tender is not permitted to take ownership of the privatized assets before fulfilling the investment and/or social conditions. Before fulfilling such conditions, the winner is permitted to vote the shares, except that on a number of fundamental decisions, the winner cannot vote without first "coordinating" its position with the state property management authority. Money spent on fulfilling investment or social conditions is not

¹¹ See Privatization Program for 1994, sections 5.3.8, 5.4.2, approved by Presidential Decree No. 2284, December 24, 1993; Regulation on Special Voucher Auctions, sections 5.3, 5.5, approved by Order of RF Committee for Management of State Property ("State Property Committee"), No. 701-r, November 4, 1992.

refundable, and if the investor fails to meet final or interim deadlines concerning these conditions, the property is supposed to revert to government ownership without return of money paid until then.¹²

The use of commercial tenders is an attempt to depart from the much-criticized practice of using investment tenders provided under previous legislation. In an investment tender, the winner was determined on the basis of the size of the proposed future investment, and the shares were sold at nominal value (usually much lower than market value) immediately after the tender.¹³ The general view has been that the investment tender legislation allowed many investors to take ownership of the shares without adequate mechanisms to enforce the commitment to carry out the future investment.

The new law's remedy for this problem is likely to cause its own ill effects. Under the legislation on commercial tenders now in force, the investor's dependence on a government decision that he has satisfied the investment or social conditions of a commercial tender, and the severe consequences of failing to fulfil them, will be a deterrent to many potential participants in such tenders. Given the inadequacy of Russia's legal system in enforcing rights and obligations, it is unlikely that any workable middle ground exists between the extremes of the government-friendly commercial tender and the buyer-friendly investment tender.

¹² Law on Privatization, section 21.

¹³ State Property Committee Order No. 342-r, February 15, 1994.

D. DEBT-EQUITY SWAPS

The new Law on Privatization provides that obligations under government debt instruments can be offset by issuing securities to the holders of such instruments, which securities in turn will provide the right to obtain state-owned shares in companies. The specific rules for privatization through this method are not yet established. Before enactment of the new Law on Privatization, such debt-equity swaps were not allowed under Russian law, and the new Law provides that special legislation on these procedures is to be adopted by the Government (i.e., the executive branch, under the signature of the Prime Minister).¹⁴

IV. PRIVATIZATIONS SCHEDULED FOR 1997-1998

Russia's basic privatization legislation requires that state property be put up for sale in accordance with an annual privatization program to be approved by a law of the parliament. However, since Russia's privatization process began in 1992, political conflicts and delays in the legislative process have prevented such annual privatization programs from being adopted on a regular or timely basis. Furthermore, the privatization programs themselves have been quite general, leaving many questions to be worked out in the political process. As a result, the inventory of state property to be privatized, and the timetable for such sell-offs, have been determined to a large extent by decrees of the President and the Government.

¹⁴ Law on Privatization, sections 16, 24.

As this article was being written, privatization officials announced plans to undertake a major effort in 1997 and 1998 to sell stakes in thirty-seven of the largest and most important companies, many of which had previously not been considered for privatization, including airports, oil companies, aerospace enterprises, and arms makers such as the producer of MiG fighter planes. Although the list of specific companies for sale has not yet been publicized, these officials have said that this would be an ambitious acceleration of the privatization campaign. Parliamentary opposition to this accelerated privatization is expected, and the government has admitted that it is making an ambitious proposal in order to allow room for negotiation with the parliament.¹⁵

Following is a list of major privatizations that were planned for the next year or two, before announcement of the government's proposed expanded program discussed above. The following list is compiled from governmental decrees and reports in the business press over the past several months. Potential investors reviewing this list should bear in mind that the government's decisions on whether and when to sell a given stake have often been subject to cancellation, delay, and sudden rescheduling.

¹⁵ The Moscow Times, September 2, 1997.

A. MAJOR ENTERPRISES

1. Tyumen Oil Company

In 1996, Tyumen Oil Company was the fifth-largest oil producer in Russia. A sale of 48.68% of the company's shares by a cash auction was scheduled for the late summer of 1997. But in August, the State Property Fund, which acts as the seller of federal assets, announced that the auction would be postponed until October or November, and that the size of the stake and terms of the sale had not yet been set.¹⁶

Forty percent of the company's shares were sold by investment tender to the Alfa Group for \$810 million in July of 1997. One week before the tender was to take place, a court ordered it postponed, but two days before the scheduled tender date the court reversed its decision and the tender proceeded as scheduled. The tender was attacked as favoring Alfa by requiring that the bidder have a certain installation at another given refinery, which only Alfa had. Also, Alfa was allowed to include in-kind contributions as part of its investment bid, while investment tenders generally called for investments in cash. These conditions were allowed, and Alfa emerged as the winning bidder despite having net assets in about the same amount as its \$810 million bid. Alfa is reportedly aiming to acquire the additional stake to be privatized.¹⁷

¹⁶ The Moscow Times, August 19, 1997.

¹⁷ The Moscow Times, July 2, 1997, July 4, 1997; Kommersant Daily, July 12, 1997, July 22, 1997.

2. Rosneft

Rosneft is an open joint stock company whose assets include the Sakhalinmorneftegaz production company and seven other production subsidiaries, four major oil refining companies, and twenty-one distribution and service companies across Russia. Rosneft is considered the best of the remaining unprivatized integrated oil companies. In 1996 Rosneft was the ninth-largest producer of oil in Russia. Rosneft is involved in several major oil projects in Azerbaijan -- exploration of oilwells in the Caspian Sea and on the Caspian shelf, and participation in the Caspian pipeline project -- and has stakes in major production sharing deals off Sakhalin and the Timan-Pechora basin in Arkhangelsk.

There is a conflict as to whether the oil production company Purneftegaz, which is Rosneft's largest asset, will be included in the privatization. Purneftegaz accounted for 60% of Rosneft's current oil production capacity. It was transferred to Sidanko in 1994 by a decree of the President, and Rosneft is disputing this transfer. This issue is the subject of an appeal before the Supreme Arbitration Court that is expected to be decided in September. In mid-September, the privatization was delayed, apparently in order to await clarification of the dispute over Purneftegaz.¹⁸

¹⁸ The Moscow Times, August 14, 1997, August 19, 1997, September 13, 1997.

Current plans are to sell 7% to 12% of Rosneft shares to the company's employees; 51% by a special cash auction, in which the shares will be sold to bidders in proportion to the size of their bids; and the remaining shares by commercial tender.¹⁹ The government hopes to receive \$1 billion from the sale. Shell and Exxon have expressed an interest in bidding, as have a few powerful domestic groups: Sidanko, which is controlled by Uneximbank and Alfa Group; Lukoil; the Menatep group; and Sibneft, which is reported to be aligning for the Rosneft privatization with Gazprom and with Komitek, another integrated oil company.²⁰

3. Slavneft

Slavneft is Russia's eighth-largest oil producer. Up to 34% of Slavneft is scheduled to be sold by a cash auction toward the end of 1997. The Fuel and Energy Ministry is trying to use Slavneft as an experiment for a new method for setting the starting price for bids in privatization of oil shares that are not actively traded. Under this scheme, a preliminary cash auction would be held for a small amount of the company's shares (in Slavneft's case, 2.2%) in order to determine the market value of the shares. Then the starting price for the major stake would be set at 1.5 times the market value. Other oil companies that the Fuel and Energy Ministry has proposed selling under this scheme are Norski Oil, Siberian-Urals Oil (Sibur), and Eastern Oil. The Ministry has

¹⁹ Commerciant Daily, July 3, 1997, July 11, 1997, July 22, 1997, July 30, 1997.

²⁰ Russia Review, July 28, 1997; The Moscow Times, August 19, 1997, August 20, 1997; Commerciant Daily, July 3, 1997.

criticized the methods for setting starting prices used by the State Property Fund and the State Property Committee as being arbitrary and conducive to deals favoring groups with close ties to the government.²¹

4. United Energy Systems

United Energy Systems is one of the Russian companies that has attracted most interest by foreign investors. It is a holding company with major stakes in most of Russia's electrical power companies. Current plans are to sell 51% of the company's shares, which would almost complete the privatization of UES's shares.²²

5. Sviazinvest

Sviazinvest holds controlling blocks of shares in the long-distance provider Rostelecom and in most of Russia's eighty-five regional telecommunications companies, thus comprising approximately one quarter of the country's telecommunications market. A stake of 25% plus one share of Sviazinvest's shares (i.e., a blocking stake enough to veto certain fundamental company decisions) was sold this summer to a consortium that included Uneximbank and a company owned by George Soros. A further stake of 25% less one share is

²¹ The Moscow Times, August 16, 1997.

²² Presidential Decree No. 1334, November 5, 1992; Governmental Decree No. 949, September 18, 1995; Commercant Daily, August 26, 1997; Commercant Weekly, August 26, 1997.

to be sold in late 1997 in a commercial tender limited to Russian investors. 51% of the shares will remain in federal ownership indefinitely.²³

6. Roslesprom

Roslesprom is the largest timber company in Russia. It is a holding company with major shares in forty-seven companies which comprise almost all of the major timber companies and owns the major timber exporter, Rosexportles. Apparently all of the shares in Roslesprom will be sold, except that for three years, the federal government will keep a "golden share" (i.e., a single share carrying rights to veto certain fundamental company decisions).²⁴

7. Rosgorstrakh

Rosgorstrakh, an open joint stock company, is the successor entity of the former state insurance monopoly. It is the largest insurer in Russia, controlling 15% of voluntary insurance through over eighty subsidiaries and 2,500 branches and representative offices. The company's large branch network is considered to be attractive to potential foreign investors. The company is a candidate for World Bank restructuring assistance in the event it is privatized. The

²³ Government Decree No. 1297, November 25, 1994; Government Decree No. 618, May 23, 1997.

²⁴ Commersant Daily, August 27, 1997, September 3, 1997; Government Order No. 993, August 8, 1997.

privatization of Rosgorstrakh has been delayed pending the outcome of a lawsuit by an association of policy-holders.²⁵

8. Russian Electronics

Russian Electronics is in the process of being organized as a holding company to include thirty-two of the most viable electronics enterprises. After organization of the holding company, it is slated for privatization.²⁶

B. PARTIALLY PRIVATIZED ENTERPRISES IN STRATEGIC INDUSTRY SECTORS

During the peak of the mass privatization campaign, from late 1993 through early 1995, many enterprises in industry sectors considered strategic -- for example, communications; electric power production and distribution; extraction, refining, and sale of oil, natural gas and gas condensate; mining and processing of precious metals, precious stones, and radioactive and rare-earth elements -- were converted into joint stock companies and partially privatized, primarily by sales of shares to their management and workers by closed subscription and a portion of shares to the general public through voucher auctions. In many of these companies, the federal government retained blocks of shares generally ranging from 25.5% to 51%, or reserved a golden share (a

²⁵ Commercant Weekly, July 8, 1997; Resolution of State Duma, April 9, 1997.

²⁶ Commercant Daily, July 31, 1997.

single share with veto power over certain fundamental company decisions, for a period of up to three years, extendable by government decision.²⁷

For many of these companies, the three-year period of federal ownership of such blocks of shares is coming to an end, and these blocks of shares will be put up for sale during the coming year or two. Furthermore, in some cases the government has issued decrees calling for accelerated sale of such blocks. This is the case, for example, with two oil companies, Tyumen Oil Company (see Section IV.A.1 above) and the eastern Siberian company Vostsibneftegaz.²⁸ During the same period, the government's golden share in such companies will also expire, but this is not a privatization opportunity for outside investors; rather, expiration of the golden share will leave full voting power in the hands of the non-governmental shareholders.²⁹

C. DEFENSE ENTERPRISES

The decision has been made in principle to sell blocks of shares in a wide range of enterprises in the defense industry, enterprises involved with so-called dual technology (i.e., which is used for both military and civilian production), and enterprises engaged in the production of precise instruments and electrical

²⁷ Presidential Decree No. 2284, December 24, 1994, Section 2.3; Presidential Decree No. 1535, July 22, 1994.

²⁸ Government Decree No. 616, May 21, 1997.

²⁹ See, e.g., Government Decree No. 578, May 13, 1997.

technology. The legislation in this area calls for the government to retain between 25.5% to 51% of the voting shares of each enterprise.³⁰

Also, a decision has been made to privatize the "Voientorg" network of stores and consumer service outlets, wholesale enterprises, warehouses, transport enterprises, and retail stores that are owned by the military and have been responsible for supplying the military with goods other than armaments. The main value of Voientorg is its real estate and its sales and distribution network.³¹

D. PRIVATIZATION THROUGH INSOLVENCY

Legislation has been adopted calling for the sale of state-owned shares of companies whose financial condition the Federal Bankruptcy Agency has declared to be "unsatisfactory," i.e., insolvent.³² In particular, the light industry sector has been targeted for privatization through bankruptcy. Because Russian insolvency procedures are so undeveloped, and because of a lack of political readiness to pursue bankruptcies, this method of privatization has been used in very few cases. In fact, insolvency proceedings have in some instances led to renationalization. Some companies after privatization have given the government blocks of shares in exchange for an offset or delay of payment of

³⁰ State Property Committee Order No. 1410-r, March 13, 1997.

³¹ Government Decree No. 939-r, July 8, 1997; *Commerzant-Daily*, July 13, 1997.

³² Presidential Decree No. 1114, June 2, 1996.

taxes. For example, one of the country's major automotive companies, Avtovaz, has entered a tax debt restructuring program with the government whereby the government will receive a new issue of shares amounting to fifty percent of equity if Avtovaz fails to pay taxes under the revised schedule.³³

E. PRIVATIZATION BY INDIVIDUAL PROJECT

The government has set aside a number of companies with "special national, regional, or sectoral significance" for privatization by individual project. Such projects consist of pre-sale preparation of the enterprise, including possible restructuring, and valuation and consulting by an outside financial consultant, hired on a competitive basis, on the optimal method of sale. The following enterprises have been named for such projects: Troitsky Iodine Factory (located in the Orenburg Oblast), Karesliuda Mining Construction Combine (Karelia Republic), Tangarog Merchant Seaport (Rostov Oblast), Kama Celluloid and Paper Combine (Perm Oblast), Mosfilm Cinema Concern (Moscow), Sokol Celluloid and Paper Combine and Wood Processing Factory No. 21 (Vologda Oblast), Povarovski Machine Building Factory (Moscow Oblast), Russian Diesel (St. Petersburg), and Rosgorstrakh (City of Moscow), which is discussed in Section IV.A.7 above.³⁴

³³ Russia Review, August 25, 1997.

³⁴ Government Decree No. 363, April 1, 1997.

V. RESTRICTIONS ON PARTICIPATION BY FOREIGN INVESTORS

In the early stages of the privatization campaign, the general legislation was drafted with minimal restrictions on foreign participation. The architects' design in allowing foreign participation was to maximize revenue from privatization (either to the government or, through vouchers that investors would buy on the secondary market, to the public) and to bring international business and management practices to Russia. However, as the campaign moved into the implementation stage, there was increasing pressure on the government to restrict foreign participation. The government became more vulnerable to such pressure as local business interests began to accumulate capital and political influence, and more and more ad hoc restrictions on foreign investors were introduced.

Under the new Law on Privatization, the annual privatization program must specify which property is to be privatized with restrictions on foreign companies or foreign-owned Russian companies.³⁵ The privatization program adopted at the end of 1993, which is still in effect, provides that foreign investors cannot participate in the privatization of certain types of enterprises unless this restriction is waived by the federal government or, where applicable, the government of a constituent republic. The enterprises subject to this restriction are those for whom defense accounts for over 30% of output; oil and gas companies; enterprises engaged in mining and processing of strategic material ores, precious and semi-precious stones, precious metals, or radioactive

³⁵ Law on Privatization, section 4.3.

and rare-earth materials; and transport and communications enterprises. If foreign investors are permitted to participate in a privatization auction or tender for shares in such a company, information on a prevailing foreign investor must be submitted to the Federal Security Agency, and the government can cancel such investor's acquisition on national security grounds.³⁶

Foreign investors have participated very little in privatization sales in Russia. The main reason for this reticence is probably not the legal restrictions on foreign participation, because in most cases such restrictions either did not apply or were waived. Rather, foreigners have been deterred by the chaos of the process and the general political, business, and legal risks of investing in Russian companies. As foreign companies gain experience in Russia, and an ability to assess these risks, foreign participation in privatization has increased. Nevertheless, foreign participation has remained far below the level hoped for by the professional investment community and the early advocates of foreign investment within the Russian government.

VI. LEGAL RISKS CONNECTED WITH PRIVATIZATION

This section will focus on legal risks connected with privatization (but will not discuss general legal risks of the Russian environment, to the extent they are distinguishable). The first problem in participating in privatization is the problem of information: announcement of a sale, and information necessary to evaluate whether the target company would be an attractive investment. This

³⁶ Privatization Program for 1994, Article 10.

is not strictly a legal problem, but it is a problem that the legislation attempts to deal with but cannot do so effectively. As for announcements of sales taking place, the legislation has established requirements for announcements to be made a minimum period before the sale: under current legislation, the announcement must be made at least forty-five days before bids are received.³⁷ Similar provisions were included in previous legislation.

There have been two common problems with announcements. First, the publications in which such announcements were made have not been widely and rapidly circulated. This problem is the result of the general upheaval in Russia's mass media over the past several years and cannot be simply addressed by stricter privatization legislation. Second, after the announcement of a privatization, in many cases there are delays in implementing it because of political controversies, business lobbying, and lawsuits. When a privatization is rescheduled, often the announcement procedures are not observed and the privatization is held within days after the final decision is made on bidding rules and the deadline for submitting bids. Because of the difficulty of obtaining information about privatization schedules from official sources earlier enough to make an investment decision, most foreign investors work with the Moscow-based brokerage and investment banking companies in planning an investment through privatization.

³⁷ Law on Privatization, section 18.

The other informational problem, performing due diligence on companies, is also something that the legislation attempts to address. The legislation contains some basic requirements regarding information about the company that must be included in public announcements of the privatization, and information that must be made available to potential investors upon request. However, this required information is quite minimal,³⁸ and given the state of accounting and auditing in Russia, it is not likely to be very illuminating. As for the right to obtain other information from the company itself, given the general state of crime, law enforcement, and minority shareholders' rights, it is generally considered that unsolicited visits to a company are not the best way to begin a hostile takeover attempt of a Russian company.

Many general legal risks in Russia also come into play in the privatization context: for example, the risk of losing a deposit submitted with a bid as a result of a bank failure; and the lack of confidence in the court system (although this confidence has been increasing over the past two years or so) in the event of a dispute on whether the bidding was conducted according to the rules.

A further risk concerns the security of property rights acquired through privatization. The new Law on Privatization provides that a privatization transaction can be declared invalid in the following cases:

- violation of privatization legislation

³⁸ See Law on Privatization, section 18.

