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Legal Framework of Privatization in Russia

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The current power struggle between the Congress of People's Deputies and President Boris Yeltsin raises the dynamic question of the future of democracy and economic reform in Russia. In theory, the conflict between the Congress and the President is centered on a fundamental constitutional issue, the division of powers between the legislative and executive branches of government. In fact, the real issue is the struggle for survival between a communist-elected Congress that draws its powers from a Brezhnev-era Constitution, and a democratically elected President that represents the fledgling parties and movements in Russia committed to reform and conversion to a market-oriented economy.

This Article focuses on one of the most important elements of economic reform in Russia — the legal framework of privatization. It examines the ability of the legal structures to support the economic reform, the prospects for foreign investors and, when appropriate, compares the experience of Russia with the approach adopted by the Eastern European countries. Additionally, this Article provides a brief analysis of the similarities and differences between the Russian and Moscow privatization plans.

I. OVERVIEW OF PRIVATIZATION IN RUSSIA

The basis for privatization and marketization in the Russian economy was set forth in the Program for Deepening the Economic Reform in the Russian Federation (Program) adopted on July 17, 1992.¹ The Program is a comprehensive 280 page document that discusses the general goals of the reform — liberalization and stabilization, institutional changes, structural policy, foreign investment, social policy and expected results.

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1. ROSIISKAYA GAZETA, July 17, 1992, at 1.

According to the Program, reforms will deregulate the economy, stabilize the financial and monetary system, privatize state-owned property, develop entrepreneurship, make structural adjustments to and demilitarize the economy, and create a competitive market environment and an active social policy.

The Program demonstrated impressive results within six months after its implementation. According to Russian sources, as of January 1, 1993, approximately 46,000 enterprises of an estimated 226,657 enterprises have become private, and the budget profit received from privatization amounted to 164 billion rubles (R).² This is almost a three-fold increase since September 1992.³ These results prove that the program is gaining momentum. So far, the Yeltsin government has been successful in laying the foundations for the basic legal framework necessary to implement the Program. Considerable efforts, however, will be needed to maintain the momentum necessary to ensure steady, and complete privatization throughout Russia.

II. GENERAL LEGAL BACKGROUND

The Russian legal system still carries the same basic structure as the former USSR: a hierarchy of the Constitution, a body of basic law known as the Fundamentals of Civil Legislation, laws, ordinances, and normative acts or regulations. With the creation of a new Russian state and the introduction of a market-oriented economy, however, changes have occurred at all levels of this system.

Unlike some of the newly independent states, the Russian Federation has not yet adopted its own Constitution. The old Russian Soviet Federal Socialist Republic (RSFSR) Constitution is still valid in Russia, although with numerous amendments. The most recent amendment was adopted on April 21, 1992.⁴ The adoption of a new draft Constitution, designed to break with the communist past and provide the legal basis for the develop-

2. Chubais Discusses "People's Privatization" at Conference, F.B.I.S., Feb. 23, 1993, at 23.

3. See 7.2% of Russia's Enterprises Privatized, F.B.I.S., Sept. 18, 1992, at 21.

4. Law No. 2708-1 of the Russian Federation on Amending and Supplementing the Constitution (Fundamental Law) of the Russian Soviet Federative Socialist Republic, ROSSIISKAYA GAZETA, May 16, 1992, at 3. The amendments introduced *inter alia* the new name of the republic: Russian Federation or Russia. The RSFSR Constitution was adopted in 1978 and, as well as the Constitutions of the other republics, was molded along the lines of the 1977 USSR "Brezhnev" Constitution.

ment of a democratic state and free market economy, is at the center of the current political debate in Russia.⁵

The Fundamentals of Civil Legislation (Fundamentals), which define the objectives of civil law and contain the basic provisions of the most important institutions of civil law, occupy an intermediate status between the Constitution and ordinary laws. Under the old Soviet system, the Fundamentals contained civil law provisions which every republic had to incorporate into its civil code.⁶ These basic principles were then further developed by the civil codes of the union republics. The last Soviet Fundamentals were adopted in 1981. In 1991, the Gorbachev government adopted new Fundamentals, which were to become effective on January 1, 1992. Before the new Fundamentals took effect, however, the Soviet Union was dismantled. Taking a pragmatic approach, the Russian Parliament did provide that the 1991 USSR Fundamentals would apply until the adoption of a new Russian Civil Code, except for provisions that spell out the powers of the old USSR in civil legislation, or that contradict the Russian Federation Constitution or legislative acts adopted after the sovereignty of the Russian Federation was declared on June 12, 1990.⁷ In general, the new Fundamentals are quite liberal and market-oriented. Their most important achievement is the abolishment of the supremacy of state property.⁸ The new Code, which is currently being drafted by the Research Center for Civil Law, is expected to be enacted by January 1, 1994.⁹

III. NEW ECONOMIC AND PRIVATIZATION LEGISLATION

In a nutshell, the privatization plan will proceed as follows: First, large state and municipal enterprises are converted into

5. *Draft Constitution Submitted*, ROSSIISKAYA GAZETA, Mar. 3, 1992, at 1. The analysis of the Constitutional Referendum problem falls beyond the scope of this article.

6. *Russian Federation Reaches Back to 1991 USSR Fundamentals of Civil Law*, 3 SURV. E. EUR. L. 5, Aug.-Sept. 1992, at 5.

7. Decree No. 3301-1 of July 14, 1992, "On the Regulation of Civil Legal Relations in the Period of Carrying out Economic Reforms," ROSSIISKAYA GAZETA, July 24, 1992, at 2.

8. For a discussion of the 1991 Fundamentals see *Overview of the 1991 Fundamentals*, 2 SURV. E. EUR. L. 6, Aug. 1991, at 4.

9. Interview with Mikhail Mitiukov, Chairman of the Supreme Soviet Committee on Legislation, on the Draft Civil Code, ROSSIISKAYA GAZETA, July 24, 1992, at 4. The draft Code draws heavily on the experience of other civil law countries, especially the Netherlands, which recently adopted amendments taking into account the EEC experience.

joint stock companies.¹⁰ The purpose of this conversion, also known as "denationalization" or "corporatization," is to transfer ownership of the assets of each enterprise from the State to the newly organized companies. The State obtains at least forty-nine percent of the shares, and exercises control by acting through a specially appointed Committee.

Next, all or some of the total shares in these new joint stock companies are sold to private investors who can trade them freely, thus creating a market for securities.

Finally, personal privatization vouchers are issued to allow private Russian citizens to buy shares.¹¹ These citizens are encouraged to participate in the reform, thus creating middle-class owners actively involved in restructuring the economy.

A series of new laws, regulations and programs, discussed below, details the elements of this simple structure.

A. LAW ON PRIVATIZATION

The Russian Law on Privatization of State and Municipal Enterprises (RLP) was adopted on July 3, 1991, and amended on June 5, 1992.¹² It establishes the structure for denationalization of state-owned enterprises, the first stage of the privatization process. According to RLP article 1, "privatization" means the acquisition by citizens and joint stock companies of enterprises, shares in enterprises, and tangible and intangible assets from the state and local soviets. The privatization of land is specifically excluded.¹³

RLP article 3 provides for a three-year privatization program. The program, which was developed by the Government and ratified by the Supreme Soviet, lists the enterprises to be

10. The same procedure has been used in all Eastern and Central European countries that have adopted privatization programs, and in Germany, Britain and Italy in the reorganization of state concerns. See generally WALTER JERMAKOWICZ, *PRIVATIZATION IN POLAND: AIMS AND METHODS, THE INTERNATIONAL FOUNDATION FOR CAPITAL MARKET DEVELOPMENT AND OWNERSHIP CHANGES IN THE REPUBLIC OF POLAND-CENTER FOR PRIVATIZATION*.

11. The terms privatization "check" and privatization "voucher" are used interchangeably throughout this article.

12. RLP, DELOVOI MIR, July 21, 1992, at 6.

13. With respect to the privatization of land, President Yeltsin signed Decree No. 631 of July 14, 1992, "On Confirming the Procedure for the Sale of Land Tracts During Privatization of State and Municipal Enterprises, for Extension of and Additional Construction by These Enterprises, and Also on Land Tracts Offered to Citizens and Associations of Citizens for Entrepreneurial Activity," ROSSIISKAYA GAZETA, June 18, 1992, at 4. For a discussion of the provisions of this Decree with regard to foreign investors see *infra* Part III.I.

privatized during the first year and proposes enterprises to be privatized during the two subsequent years.¹⁴ The 1992 Program contains a list of five types of enterprises: 1) enterprises which cannot be privatized, such as the Central Bank, certain enterprises in the defense industry, and objects with cultural and historical value; 2) enterprises which can be privatized only with the approval of the government of the Russian Federation or the governments of the republics included in the Russian Federation, such as utilities, commercial banks and telecommunications; 3) large enterprises, important to the economy, which can be privatized only by decision of the Committee on Property in conjunction with the relevant branch ministry, such as maritime, railway, aviation and river transport enterprises; 4) enterprises which can be privatized only through local privatization programs, such as public transport and small municipal enterprises; and 5) enterprises which must be privatized because they are crucial to the development and functioning of a free market, such as those involved in commerce and trade, construction, food processing and light industry.¹⁵

In addition, in accordance with RLP article 3(3), Decree No. 1392 allows the Government or the State Committee on the Ad-

14. Similar Programs have been adopted by some Eastern European countries. In Bulgaria, privatization is carried out according to an Annual Program developed by the Privatization Agency and approved by the Council of Ministers. Article 2 of the Bulgarian Law on Conversion and Privatization of State and Municipal Enterprises, STATE GAZETTE 38, May 8, 1992, at 1 [hereinafter BLP], English text and commentaries published in 1 BULGARIAN LEG. DEV. 3, Aug., 1992. In Poland, the Sejm, the lower chamber of the Polish Parliament, adopts Annual Privatization Directives. Article 2(1) Law on Privatization of State Owned Enterprises of July 13, 1990, 29 I.L.M. 1226 (1990) [hereinafter PLP]. In Hungary, a whole network of privatization programs has been introduced by different laws such as Law XIII on the Conversion of Economic Organizations and Business Associations (May 30, 1989) as amended by Law LXXII of 1990, and Law LXXIV on the Privatization of State-owned Companies Engaged in Retail Trade, Catering and Consumer Services (Sept. 18, 1990), Hungarian Rules of Law in Force, No. 25, at 1573 and 1610. In Czechoslovakia (author's note: throughout the text reference is made to Czechoslovakia because the laws and regulations discussed were adopted before the division of the country into the Czech and Slovak Republics) the initiative is left to individual enterprises, which must submit their own privatization projects for approval by the Federal Ministry of Finance or competent state administration agency. *Act on the Conditions of Transfer of State Property to Other Persons ("Large-Scale" Privatization Law) of February 26, 1991*, (CSLP), No. 92/1991 Collection of Laws, CENTRAL & EASTERN EUROPEAN LEGAL MATTERS 2, Parker School, Columbia University.

15. For the complete list see Point 2, State Program on Privatization of State and Municipal Enterprises in the Russian Federation for 1992 (RPP), KOMMERSANT, July 8-15, 1992, at 20.

ministration of State Property (GKI) to elect to keep as federal property for a period of three years a controlling share of stocks of certain enterprises which are important to the Russian economy.¹⁶ Thus, article 3(3) and Decree No. 1392 effectively introduce the concept of "Golden Share," providing veto power to the listed authorities over certain key issues relating to the management and activity of a joint-stock company.¹⁷

The preparation of the 1993 Draft Program on Privatization,¹⁸ which draws from the experience and results of the 1992 Program, has been surrounded by a great deal of controversy and has not yet been adopted. According to Anatoliy Chubais, the Russian Deputy Prime Minister and President of the GKI, the 1993 Program was withdrawn in order to give more rights to the regions within the Russian Federation, in accordance with the Federation Treaty.¹⁹ Privatization in 1993, therefore, will continue according to the provisions of the legal regime currently in place.

B. PRIVATIZATION AGENCIES

Russia has adopted a two-tier system of state agencies to regulate the privatization process.²⁰ The GKI is responsible for planning and controlling the privatization process. The GKI drafts the privatization program that is submitted to the government and ratified by the Supreme Soviet, and sets up local, regional and district committees in charge of planning

16. Decree No. 1392 on Measures for Realization of Industrial Policy During Privatization of State Enterprises, *ECONOMICHESTKAYA GAZETA* No. 48, Nov. 1992, at 18.

17. For example, the controlling block of shares of telecommunications enterprises during their conversion into joint-stock companies shall remain under federal ownership for a period of three years. Decree No. 1003, art. 1, of Dec. 22, 1992, *Decree on Privatization of Communications Enterprises*, F.B.I.S., Jan. 15, 1993, at 31.

18. F.B.I.S., Feb. 24, 1993, at 62.

19. *Chubais on Refinements to Privatization Program*, F.B.I.S., Feb. 25, 1993, at 33. It seems more realistic, however, to interpret the withdrawal of the 1993 Program by President Yeltsin as a maneuver to avoid a premature confrontation with Congress.

20. In Bulgaria, the Privatization Agency (PA) is the authority charged with organizing and controlling the privatization process. BLP, *supra* note 14, art. 10. Depending on the book value of the fixed assets of a company, the Council of Ministers, or another ministry which has jurisdiction, may need to authorize the privatization process. *Id.* art. 3. In Poland the Minister of Ownership Transformation (MOT) is in charge of the privatization process, and the State Treasury plp performs the role of the Property Fund. PLP, *Supra* note 14, arts. 1, 6. In Hungary, Parliament controls the State Property Agency (SPA) and the State Office of Accountability supervises the SPA.

privatization within their jurisdiction.²¹

The actual sale of privatized enterprises is conducted through an executive body, which at the Federation level is the Russian Fund of Federal Property. Similar Funds have been established in the regions, districts and cities. The Fund is a government entity and is accountable to the Supreme Soviet of the Russian Federation. The Fund also acts as the state's sole stockholder of the newly converted companies. In order to prevent unnecessary interference in the day-to-day management of a company, however, only twenty percent of the shares of an enterprise held by the Fund are voting, while the rest are converted into non-voting shares. Upon their sale, non-voting shares are converted back into voting shares.²²

C. PRIVATIZATION PROCEDURE

For the purpose of privatization, the 1992 Program divides all enterprises into three categories:

1. Small enterprises with up to 200 workers and assets of less than one million rubles. Shares in these enterprises will be sold at auctions as whole entities, without prior conversion to joint-stock companies;
2. Enterprises with more than 1000 workers and assets exceeding fifty million rubles. These must be converted to open joint-stock companies as the first step in privatization;²³ and
3. All other enterprises can be privatized using either of the above procedures.

The process of privatizing a state or municipal enterprise may be started by almost anyone, including its employees, the management, and potential buyers. This last category may include foreign legal persons, bankers, creditors, or local or state property committees.²⁴ A petition to start the process must be

21. RLP, *supra* note 12, arts. 4, 5.

22. *Id.* art. 6(3).

23. Special rules for the conversion of such enterprises are provided for in Decree No. 721 and in the Statute on Commercialization. See *infra* text accompanying notes 29-30.

24. RLP, *supra* note 12, art. 13. This willingness to consider proposals from almost any reasonable source is typical of privatization laws. In Bulgaria, the initiative may come from the management, employees, the PA or ministry having jurisdiction. BLP, *supra* note 14, art. 4. In Poland the initiative may come from the bottom (from the employees or the director), or from the top — from the competent Minister. PLP, *supra* note 14, arts. 5, 6. In Czechoslovakia, a "privatization project" can be put forward by practically anybody such as ministry, municipality, M.P., or enterprise. CSLP, *supra* note 14, art. 7. In Hungary, the initiation may come from the plan of the SPA, by the company or by an

registered with the appropriate Property Committee, or local GKI. The purpose of this procedure is simply to ensure that the enterprise is not excluded from privatization by the Privatization Program, and that the prospective buyer satisfies the requirements of RLP article 9.²⁵ The decision, which must be adopted within two weeks, becomes legally binding.²⁶

Once the petition to privatize an enterprise is approved, a privatization board is established for the enterprise. This board is a sub-committee of the local committee of the GKI, and its president is appointed by the local GKI. Within a specified deadline, the board must prepare a detailed privatization plan which must specify the methods and deadline for privatization, the initial value of the enterprise, and the amount of the statutory capital. The plan must be subsequently coordinated with the local Council of People's Deputies and approved by the appropriate Property Committee. If the Council of People's Deputies disapproves the plan, the board must devise a new one. If there is further disagreement, the Property Committee makes the final decision.²⁷ Once the plan is approved, the enterprise is included in the schedule for sales, tenders and auctions.²⁸

For enterprises subject to conversion into joint-stock companies, the Decree on conversion of state enterprises and the accompanying Statute on Commercialization,²⁹ adopted less than one month after the amendment of the RLP, provide for a slightly different procedure and time frame. According to the statute, enterprises subject to conversion must establish priva-

outside entity, for example takeover proceedings initiated by foreign or domestic investors.

25. For an explanation of the requirements of RLP art. 9 see *infra* text accompanying notes 46-47; RLP, *supra* note 12, art. 14.

26. *Id.*, at art. 5(3); see also Decree No. 66 "On Speeding up of the Privatization of State and Municipal Enterprises," of January 29, 1992, ROSSIISKAYA GAZETA, Feb. 20, 1992, at 3.

27. The Law does not yet provide for guidelines in the case where the Property Committee disagrees with the plan.

28. RLP, *supra* note 12, art. 14. Obviously this procedure is somewhat rough and complicated. Changes are expected after the GKI gains more experience. The process is further burdened by the fact that Property Committees are specifically denied the opportunity to delegate power to other bodies with more than 25% state participation. In Bulgaria, in order to speed up the process, such authority is divided between the Privatization Agency, five ministries and local municipal councils. BLP, *supra* note 14, art. 3.

29. Decree No. 721 "On Organizational Measures for the Conversion of State Enterprises, Voluntary Associations of State Enterprises into Stock Companies," of July 1, 1992, and the attached Statute on Commercialization of State Enterprises with Simultaneous Transformation into Open Stock Companies of July 1, 1992, ROSSIISKAYA GAZETA, July 7, 1992, at 4.

tization boards.³⁰ Initially, the board was required to prepare the privatization documents such as the privatization plan, appraisal and Charter no later than October 1, 1992. For privatizations after that date, the statute requires the local GKI board to prepare the documents. Once the documents are submitted, the GKI has seven days to study them and an additional seven days to make changes. When approved by the Property Committee, the plan becomes a decision for conversion, and becomes legally binding.³¹ Although the October deadline was not realistic and was not met in many cases, this Decree provides further evidence of the Yeltsin government's interest in proceeding with privatization at a rapid pace.

D. METHODS OF PRIVATIZATION

The RLP defines four methods of privatization: an open auction, a closed auction or tender, a tender with conditions, and a buyout of leased property. The 1992 Privatization Program and the Statute on the Sale of Shares in the Process of Privatization,³² detail and expand these procedures and include as variants "commercial tenders" and "investment auctions."³³ With the exception of small enterprises, all enterprises may be privatized using any of the privatization methods.

Small enterprises and the assets of liquidated enterprises are sold at an *open auction*. This is a simple procedure; the win-

30. Statute on Commercialization, *supra* note 29, Point 3.

31. *Id.* Points 4, 6.

32. ECONOMICHESKAYA GAZETA No. 47, Nov. 1992, at 11. In order to guarantee a market for privatization checks, the Statute on Specialized Check Auctions, in conjunction with the Statute on the Sale of Shares, provide that 80% of the shares of state enterprises, and 35-90% of the shares of municipal enterprises (with the exception of those sold at closed subscription) will be sold to the public only in return for privatization checks. KOMMERSANT, Nov. 16-22, 1992, at 19.

Decree No. 1705 on "Broadening the Possibilities for Participation of the Population in Specialized Check Auctions introduces two amendments. First, it provides for a possibility of increasing the number of shares for sale by their division into smaller denominations. Second, it allows 5% of the total number of shares to be sold for cash in order to cover the expenses of organizing the auction. KOMMERSANT, Jan. 4-10, 1993, at 12.

33. Bulgaria provides for open sales, auctions of blocks of shares, public tenders, and negotiations with potential buyers. BLP, *supra* note 14, art. 25. Under Polish privatization, shares may be sold at auctions, through public offering or through negotiations. PLP, *supra* note 14, art. 23. CSLP, *supra* note 14, article 14 provides only for auctions. In Hungary, the favored methods are public offering, closed bids and private auctions.

ner of the auction is the person bidding the highest price.³⁴

Stock in large enterprises may be sold at *closed auctions* or tenders, with a procedure similar to that used to sell treasury bonds. Interested bidders mail bids for specified amounts of stock to the tender commission; the winners are those offering the highest price.³⁵

Tenders with conditions are used when the buyer of an enterprise must comply with certain conditions defined by the State or local Committee on Property. Such conditions are supposed to be limited to requirements to maintain the same line of production, to keep a certain number of employees, to invest a given level over a specified period of time, and to maintain certain social programs. The imposition of additional requirements is prohibited.³⁶ This method of privatization is used with various enterprises that are either very important to a region's economy, national security or social welfare. The winner of the tender is the participant who satisfies all of the requirements and offers the best price.³⁷

A *buyout of leased property* allows the employees of an enterprise to sign a lease contract with a provision for buyout upon the expiration of the contract. The lease contract might have been signed either before or after the adoption of the RLP.³⁸ In either case, the employees are allowed to purchase the leased property according to the buyout terms of the lease contract, the general rules defined in RLP articles 15, 20, 21 and 24, and the provisions of the regulations adopted by the President and the GKI.³⁹

Investment auctions are organized when the buyer has to comply with an investment program to develop the business. These are merely a variant of a tender with conditions; the winner is the bidder whose proposal best meets the criteria of the investment program, not necessarily the one who offers the highest price.⁴⁰ This method may be attractive to investors because most of the offered capital will be injected directly into the

34. Decree No. 66, *supra* note 26, app. 4, Temporary Provision on the Privatization of State and Municipal Enterprises on Auctions, art. 4(1) and 4(2).

35. *Id.* app. 4, art. 4(3).

36. *Id.* app. 5, art. 2(8).

37. RLP, *supra* note 12, art. 20; Decree No. 66, *supra* note 26, art. 2(9).

38. RLP, *supra* note 12, art. 15.

39. Decree No. 1230 "On Regulation of Lease Relations and Privatization of Property Leased by State and Municipal Enterprises," ROSSIISKIE VESTI, No. 98, Nov. 1992, at 1, and Instruction on Privatization of Property Leased by State and Municipal Enterprises, KOMMERSANT No. 6, Feb. 8-14, 1993, at 25.

40. RPP, *supra* note 15, point 5.6.2.

business for the agreed upon investment programs rather than going to the state. In effect, the state sells the enterprise, at a reduced price, to a bidder willing and able to invest enough to develop it.

Finally, *commercial tenders* with a limited number of participants may be used for enterprises in rural areas, small villages, and in the Far North. The participants in such competitions may be limited to the employees of the enterprise, local citizens, or individuals who were deported from the region during the period of mass repression. Commercial tenders are limited to commercial companies, restaurants, and companies engaged in food processing or farm equipment production.⁴¹

E. APPRAISAL OF ENTERPRISES

An essential part of preparing an enterprise for sale is conducting an inventory and making a comprehensive financial appraisal. This is one of the most difficult problems because of the absence of Western style accounting principles and the lack of people in Russia with the necessary training.⁴²

According to RLP article 17, appraisals must follow methodological instructions developed by the Committee on Property, details of which are spelled out in the "Temporary Methodological Instructions on the Appraisal of the Value of Objects Subject to Privatization" (Instructions).⁴³

In general, valuations are based on asset appraisals. Fixed assets and other tangibles are valued at book value, usually at depreciated historical cost. The current inflation of the ruble, however, may render such valuations completely meaningless, and some sort of valuation at current costs, which appears to be an allowed method, will probably be used.⁴⁴ A similar treatment of intangible assets, which the Instructions also require to be valued at depreciated historical cost, seems likely.

Although the Instructions seem to be comprehensive, there is little experience in applying them, and it is not clear whether they will prove workable in practice. For an investor, valuation based on book value is likely to be meaningless because in most

41. *Id.* point 5.6.1.

42. The same problem exists in all Eastern European countries. For pragmatic reasons, all of them allow and encourage the participation of foreign experts. In Russia, the foreign advisory team on privatization is led by Deloitte & Touche.

43. Decree No. 66, *supra* note 26, app. 2.

44. RLP, *supra* note 12, art. 3(1)(1).

cases it will reflect the value of old and dilapidated machinery and equipment; thus it does not reflect true earnings potential. From an investor's point of view, therefore, it might be more useful to use a valuation based on current cash flow or income.

The reader should note that the government has commenced a special program for the adoption of international accounting standards, and the draft of a Law on Accounting has been submitted to the Supreme Council.⁴⁵

F. BUYERS

The RLP adopts a very liberal approach to defining potential buyers. According to article 9, only legal entities with more than twenty-five percent state ownership are barred from buying state-owned enterprises.⁴⁶ The purpose of this restriction is to prevent the transfer of property from one state or municipal enterprise to another, thus circumventing the purpose of the privatization process. The burden of proof lies with the buyer. This limitation will apply to some existing joint ventures in which the Russian partner is a state company.

The RLP, however, favors employee-led bids for their own enterprises. A special provision allows employees who wish to participate more actively in privatization to register a special company for this purpose. If such a company represents at least one-third of the employees of an enterprise to be privatized, participates in the privatization auction or tender, and can offer terms equal to those of other bidders, it is given priority. In addition, the special company will have the right to pay in installments over three years. The first payment, however, may not be less than twenty-five percent of the price.⁴⁷

G. PRIVATIZATION VOUCHERS

Because the purpose of converting state and municipal enterprises into stock companies is to make possible the sale of shares to private citizens or organizations, the question of how to distribute such shares has created much debate throughout East-

45. Decree No. 121 "On Measures for the Realization of the State Program for Adoption by the Russian Federation of International Accounting and Statistics Systems in Accordance with the Requirements of Market Economy," ROSSIISKAYA GAZETA, Feb. 18, 1993, at 6, and Draft Law on Accounting Activity in the Russian Federation, ECONOMICHESKAYA GAZETA No. 50, Dec. 1992, at 5.

46. In Bulgaria, the limit for state or municipal participation is 50%. BLP, *supra* note 14, art. 5(4).

47. RLP, *supra* note 12, arts. 23, 24.

ern Europe and the Commonwealth of Independent States (CIS). The debate revolves primarily around the issue of voucher distribution. Fundamentally, two different approaches are available:

First, employees of an enterprise that will be privatized may be allowed to buy a percentage of the shares on preferential terms. Bulgaria and Hungary have both adopted this method.

Second, all citizens may be issued privatization "vouchers" or certificates of a similar value which may be used to buy shares. This approach was adopted in the CSFR and Poland,⁴⁸ and was recently chosen by Russia. In addition, employees in Russia will be allowed to buy a percentage of the shares of their own enterprises on preferential terms.

The voucher approach has some significant advantages: it will give each citizen an equal start, and it will involve millions of people in the privatization process, thus encouraging the development of a large middle class. It also compensates to some extent for the lack of savings by the population. But the voucher approach also has major drawbacks: it simply replaces the anonymity of the state as the ultimate owner with the anonymity of thousands of unknown individuals who will have little or no say in the management or control of a company. Financially, it is accompanied by considerable expense and bureaucracy, and as witnessed in Czechoslovakia, may become the source of potential fraud.⁴⁹ In Hungary, "privatization coupons" or "indemnification vouchers" are issued only to compensate former owners of land taken by the state. Such vouchers can be used to buy shares in privatized companies, to buy farm land, or to cover housing costs.⁵⁰

Given the historical background of Russia, the mass coer-

48. In Poland the decision to issue vouchers rests with the Sejm, which is currently considering a draft law. PLP, *supra* note 14, art. 25. The concept, however, is that even if vouchers are issued they may be used only for investment in Mutual Funds.

49. In Czechoslovakia an unknown emigre offered citizens a guaranteed ten-fold return on vouchers in a year's time if they let him manage them. As a result, the government was faced with the prospect of one individual controlling considerable amounts of the nation's industry, with the possibility of subsequently reselling the shares to foreign interests. See *infra* note 61 for a discussion of the solution to this problem.

50. Law No. XXV On Settling Ownership Conditions, on the Partial Indemnification of Damages Caused by the State on Property of Citizens, adopted on June 26, 1991, and Law XXIV On Settling Ownership Conditions, on Providing Partial Compensation for Unjust Damages Inflicted by the State on the Property of Citizens as a Result of Enforcing Legal Provisions Adopted Between May 1, 1939 and June 8, 1949 (on file with author). Interview with Laslo

cive collectivization following the October Revolution, the forcefully propagated ideas of equality among citizens and strong communist opposition, it is not surprising that Russia has adopted the relatively egalitarian Czechoslovak model of privatization.⁵¹ Of course, all parallels should be drawn very carefully in view of Russia's larger economy and population.⁵²

In his address to the nation on the anniversary of the failed coup of August 1991, President Yeltsin announced that every citizen of Russia would be given a privatization check.⁵³ The details were spelled out in Decree No. 914 and its Supplement.⁵⁴ According to these legislative acts, checks are issued in bearer form, with a value of 10,000 R.⁵⁵ The checks are valid for one year and there is a 25 R fee for their issuance. They can be used to buy shares, invest in mutual funds (to be established later), or sold for cash.⁵⁶

Those who so elect may buy shares in any company whose shares are available, but special advantages are available to employees who wish to buy shares in their own company. These preferential terms, intended to curtail worker's opposition to privatization, are spelled out in the 1992 Privatization Program

Takacs, Consul, Embassy of the Republic of Hungary, in Washington, D.C. (Sept. 18, 1992).

51. It is interesting to note, however, that the debate over voucher distribution is not yet closed even in a country like Hungary, which is furthest along in the privatization process. There is an ongoing debate about the distribution of free vouchers to every citizen in order to create a middle class, ease economic tensions and accelerate the privatization process. *Kupa's New Privatization Program Discussed*, F.B.I.S., Feb. 22, 1993, at 16. In Bulgaria the issue of voucher distribution has also been raised, but the broad restitution programs adopted by the government appear to have neutralized this problem.

52. Given this history and the 60-70 years that have passed since property was nationalized and farms collectivized, it is understandable that the restitution of property to former owners, which has been quite widespread and successful in Eastern Europe, has not been raised as an issue in Russia.

53. *Yeltsin Addresses Nation*, F.B.I.S., Aug. 20, 1992, at 17.

54. Decree No. 914 of the Russian President "On Introducing a System of Privatization Checks in the Russian Federation" of August 14, 1992, and Supplement to Russian President's Decree No. 914 of August 14. Statute on Privatization Checks. English translation published in F.B.I.S., Aug. 26, 1992, at 19-20.

55. Approximately \$15. Compare this with the Czechoslovak "investment coupons," which are untransferable and have a value of 30,000 korunas (about \$1,000). CSLP, *supra* note 14, art. 22. The nominal price for acquisition of Czechoslovak coupons is 1,035 korunas or about \$35.

56. In view of current economic hardships, this may prove to be a very strong temptation for many citizens and a source of profit for some of the new entrepreneurs. The chances for fraud of various sorts are quite real. In the Russian press there are already reports of individuals compiling lists of retired citizens and students most likely to be willing to sell their shares for quick cash.

and the Statute on Close Subscription to Shares.⁵⁷

Employees of an enterprise may choose between three possibilities or "options" as they are called in the Program. The main differences between the three options include the level of employee participation, the amount of discount on the share price, the level of control retained by the employees over the privatized company, and the potential for foreign investment.⁵⁸ The underlying principle is that the more control the employees retain over the privatized enterprise, the less the discount they are given. As a general rule, the monetary amount of discounts and preferential terms offered to employees in Russia, as well as in Eastern Europe, is limited. The discount amount is further eroded by the low salaries, limited savings and galloping inflation. Therefore, the key roles in privatization will probably be played by Mutual Funds and large foreign corporate investors.

In the first employee option, preferred shares amounting to the lesser of 25% of the total capital or 7,000 R per person, would be distributed free of charge to the employees. In addition, voting shares amounting to 10% of the capital (but not more than 2,000 R per person) could be sold at a 30% discount. Members of management could buy an additional 5% of the voting shares. This option allows employees and management to make full use of the free and discount distribution of shares, but limits the control they could exercise. This option may be adopted by simple recommendation on the part of the employees.

The second option allows employees, through closed subscription, to buy shares representing up to 51% of the capital at market prices. This option allows the employees, by obtaining 51% of the capital, to control the privatized company, but it requires them to pay for this right at market prices. This option can only be adopted by a two-thirds vote at a general meeting of all employees.

The third option allows a group of employees to sign a management contract for one year, with the obligation to fulfill the privatization plan of an enterprise and to avoid bankruptcy. At the expiration of the contract, if all the conditions are fulfilled, the members of the group have the right to acquire 20% of the enterprise's voting shares at market prices. In addition, all employees have the option to buy 20% of all voting shares at a 30% discount, provided that the total value of shares does not exceed

57. Statute on Close Subscription to Shares at the Privatization of State and Municipal Enterprises, KOMMERSANT, July 27-Aug. 3, 1992, at 21.

58. For a discussion of foreign investors options, see *infra* Part III.I.

7,000 R per person. This third option is limited to enterprises in the middle range — those with a capital between one and fifty million rubles and more than 200 employees. As with the second option, adoption of the third option requires a two-thirds vote at a general meeting of all employees.⁵⁹

It is important for foreign investors to be familiar with the three options for privatization, this may assist them in structuring deals in Russia. Option One may guarantee the foreign investor voting control. Option Two may be preferable to companies interested in joint venture agreements. Option Three offers limited opportunities for foreign investors until the expiration of the one year contract. If the 1993 Privatization Program retains the same options, foreign investors might be able to influence the selection of privatization options through negotiations with management and employees.⁶⁰

H. SECURITIES MARKET

In order to encourage the development of a securities market, the RLP provides for the creation and regulation of licensed investment funds and holding companies.⁶¹ Decree 1186 provides the legal basis for the registration of these funds, which already exceed 300 according to some estimates.⁶² This licensing mechanism is intended to guarantee the professional and compe-

59. It seems so far that this is the option preferred by employees. This, however, raises the question of how effective such a method of privatization may be when employees, afraid of lay-offs and drastic management changes, effectively retain the right to block unpopular measures. In the absence of effective bankruptcy legislation, this simply means perpetuating the old system.

60. The 1992 Privatization Program set the deadline for the adoption of privatization plans by individual enterprises at October 1, 1992.

61. RLP, *supra* note 12, article 8, provides that such funds cannot hold more than 10% of the voting shares of, or invest more than 5% of their funds, in a single joint-stock company. A similar restriction was implemented in Czechoslovakia in order to avoid the possibility of a single fund controlling a large number of companies. See *Privatization: Bold Promise by Privatization Funds Multiplies Interest in C.S.F.R. Voucher Plan*, 9 Int'l Trade Rep. (BNA) 320 (Feb. 19, 1992).

62. Decree No. 1186, of October 7, 1992, "On Measures for the Organization of a Securities Market in the Process of Privatization of State and Municipal Enterprises, ROSSIISKAYA GAZETA, Oct. 16, 1992, at 3, and Annex No. 1, "On Investment Funds," Annex No. 2, "On Specialized Investment Funds of Privatization, Accumulating Privatization Checks of Citizens, Annex No. 3, "Model Statute of an Investment Fund," Annex No. 4, "Basic Provisions of a Deposit Contract," Annex No. 5, "Model Contract with Manager on Investment Fund Management," and Annex No. 6, "Model Prospect for Investment Fund Emissions." *Id.*

tent management of the privatization checks.⁶³

Specialized Investment Funds are those entitled to accumulate vouchers from the population for their subsequent use in the privatization process.⁶⁴ In contrast, holding companies are created during the process of conversion from state enterprises into joint-stock companies.⁶⁵ Holding companies are empowered to manage the controlling packet of shares of their daughter companies, including the "Golden Share,"⁶⁶ and are allowed to engage in investment activities.⁶⁷ It should be noted that holding companies are created only following approval from the State Anti-monopoly Committee, and cannot own the controlling packet of shares of enterprises whose market share for a product exceeds thirty-five percent of the market.⁶⁸

The basic idea behind sponsoring the establishment of a vast network of investment funds is two-fold: first, to help inexperienced citizens use their privatization checks and prevent them from being defrauded by dishonest entrepreneurial individuals; and second, to create the opportunity for citizens even in the most remote areas to participate in the privatization of any enterprise in the territory of the Russian Federation.

I. FOREIGN INVESTMENT

The 1992 Program contains a number of provisions with regard to foreign investment which complement the Russian Federation Law on Foreign Investment. In general, restrictions on foreign investors in Russia have been substantially eased, and foreign investors are actively encouraged to participate in the privatization of state and municipal enterprises.⁶⁹ The 1992 Program, however, limits foreign participation to open auctions, closed auctions, or tenders and investment auctions. Two areas require additional permission. First, foreign acquisition of small

63. Regulation No. 695-r of November 4, 1992, "On Confirming the Statute on Licensing the Activity of Specialized Investment Funds Accumulating Privatization Checks from Citizens, of their Managers, and on the Procedure on Suspending and Revoking of Licenses," KOMMERSANT, Nov. 9-15, 1992, at 15.

64. Decree No. 1186, *supra* note 62, annex no. 2, art. 1(1).

65. Temporary Statute on Holding Companies Created During the Reorganization of State Enterprises into Joint-Stock Companies, ROSSIISKIE VESTI No. 98, Nov. 1992, at 1.

66. *See supra* note 17 and accompanying text.

67. Decree No. 1186, *supra* note 62, art. 1(4).

68. *Id.* art. 2(3).

69. Article 37, *Law on Foreign Investment in the RSFSR*, of July 4, 1991, 31 I.L.M. 397 (1992). For a brief discussion of the law see the introductory note by W. G. Frenkel.

enterprises (those with less than 200 employees and assets of less than one million rubles) is subject to approval from the local Soviet. Second, for certain sectors of industry, such as energy, precious metals and radioactive materials, the Government must further specify whether foreign investment will be allowed.

Other limitations not specifically mentioned in the program, are excluded. It appears that the statutory limitations on foreign investment should be narrowly construed.⁷⁰

The Program for Deepening the Economic Reform also encourages foreign investment by allowing ninety-nine year leases on land,⁷¹ the conclusion of bilateral investment guarantee agreements, granting tax deductions and tax holidays for joint ventures, and encouraging the development of a network of free economic zones.⁷² The provision on lease of land has been further liberalized with the adoption of a new decree on the sale of land (DSL),⁷³ which takes a big step toward allowing the ownership of land by foreigners. The provisions of the DSL can be summarized as follows:

- investors will be allowed to purchase commercial land either as part of a privatized enterprise or as additional acreage needed for expansion;
- the DSL applies to all types of land except areas restricted for general public use, streets, rivers, agricultural land, sites contaminated with hazardous waste, and lands regulated by the Law on Underground Resources;
- the land sale is a transaction separate from the privatization of

70. The BLP does not restrict foreign investors, but the general provisions of the Bulgarian Law on Foreign Investment, requiring licensing for foreign investment in certain sectors of the economy, still apply. In Poland, foreigners may not acquire more than 10% of the shares owned by the State Treasury without permission from the Foreign Investment Agency. PLP, *supra* note 14, art. 19(2). Foreigners, however, may freely acquire shares on the secondary market. In Czechoslovakia, a certain number of shares may be reserved for Czechoslovak citizens. CSLP, *supra* note 14, art. 6. In response to public pressure, the Hungarian government has drafted a bill that would give priority to Hungarian investors over foreigners in the privatization of state-owned companies. *Hungarian Proposal Would Favor Domestic over Foreign Investors*, 9 Int'l Trade Rep. (BNA) 988 (June 3, 1992).

71. In Bulgaria foreigners may acquire land if they are incorporated in Bulgaria. BLP, *supra* note 14, art. 5(2).

72. Program, *supra* note 1, point 5. Russia's purpose in establishing free economic zones is distinct from the goal of the Chinese model of free economic zones. Unlike the situation in China, free economic zones in Russia are established for attracting foreign capital, not domestic capital. See *Effects of Free Economic Zones Analyzed*, F.B.I.S., Apr. 5, 1993, at 36, for a discussion of Russia's free economic zones.

73. Decree No. 631, *supra* note 13.

an enterprise, although this will not pose a problem as long as the land does not fall into a category restricted for sale;

- the buyer of the land may be any legal entity or individual, domestic or foreign, as long as the conditions of RLP article 9 are satisfied;
- the price of the land is to be determined according to the newly enacted law on payment for land;
- land sales can be conditioned on meeting certain special-use requirements.

It is important to note that all payments for privatized enterprises must be made in rubles, and that foreign investors are allowed to use their accumulated ruble earnings.⁷⁴ Although RLF article 37 appears to control currency exchange rates for foreign trade, this provision is clearly outdated, having been superseded by the decision of the Central Bank of Russia to introduce a single foreign exchange rate as of July 1, 1992.⁷⁵

In order to facilitate foreign investment, an international foundation for promoting privatization and foreign investment has been established in Russia to provide information, expertise, and legal assistance to foreigners.⁷⁶ In addition, as of June 4, 1992, the Overseas Private Investment Corporation (OPIC) provides direct loans, loan guarantees, and political risk insurance for U.S. investments in Russia.⁷⁷ Furthermore, on June 17, 1992, Former U.S. President George Bush and President Yeltsin signed a Bilateral Investment Treaty Concerning the Encouragement and Reciprocal Protection of Investment, which has since been submitted to the U.S. Senate for ratification.⁷⁸ Once

74. Lithuania has recently taken a different approach by adopting a special statute on auctions for convertible currency. Statute on Privatization of State Property for Freely Convertible Currency, DELOVOI MIR, Aug. 12, 1992, at 14.

75. This rate is fixed by the Central Bank, twice a week, according to the results obtained at the Moscow Interbank Currency Exchange and it currently fluctuates around 570 R for a dollar. *Weekly Survey of Currency Exchange Markets*, F.B.I.S., Mar. 3, 1993, at 35. The legal framework for the foreign currency operations was established by the adoption of the Law on Currency Regulation and Control, KOMMERSANT, Oct. 13-19, 1992, at 5. Unfortunately, however, the terms of the law are very broad and it can not become fully operative without the adoption of a considerable number of Central Bank decrees or regulations.

76. *Privatization Opened to Foreign Investment*, F.B.I.S., July 10, 1992, at 47.

77. According to a spokesman for OPIC, so far some 300 U.S. companies have registered applications for insurance. *Export Financing: OPIC Programs Now Available for U.S. Investors in Russia*, 9 Int'l Trade Rep. (BNA) 1006 (June 10, 1992).

78. Treaty Concerning the Encouragement and Reciprocal Protection of Investment, June 17, 1992, 31 I.L.M. 794.

ratified, the treaty will provide certain guarantees to investors in both countries and will protect American businessmen against investment risks in Russia.⁷⁹

IV. MOSCOW PRIVATIZATION PROGRAM

Shortly after the adoption of the Russian 1992 Privatization Program, the mayor of Moscow signed a legislative package intended to bring privatization in Moscow into conformity with the Federation program.⁸⁰ The following analysis focuses on the main points and differences of this package with the federation program.

The Moscow Privatization Program does not contain an enterprise buy-out provision. The mayor's resolution repeals a November 1991 resolution on privatization, which provided for a buy-out of certain categories of enterprises by their employees. The repealed resolution is similar to Option Two of the Russian 1992 Privatization Program, which provides that employees may acquire up to fifty-one percent of the shares.⁸¹

One part of this legislative package, the Statute on Close Subscription to Shares, applies whenever shares are distributed among employees and management under either Option One, Two or Three of the Russian 1992 Privatization Program. The Statute regulates the distribution of shares when the demand for discount shares exceeds the availability of such shares, and determines details such as the amount of the minimum initial payment and the use of privatization checks.

The 1992 Moscow Privatization Program was adopted upon proposal from the Moscow Committee on Property, and puts an end to the disagreement between the Mayor's office and the Committee. Basically, the disagreement centered around the authority to sell state property. It was resolved by the provision

79. The Treaty guarantees the right to repatriate profits (article IV), provides for non-discriminatory treatment of U.S. investors (article II), allows third-party international arbitration (article VI), and guarantees prompt, adequate and effective compensation in convertible currency in the event of expropriation (article III). Text published in *RUSSIA AND COMMONWEALTH BUS. LAW REP.*, Aug. 10, 1992, at 9.

80. Resolution No. 250-PM of August 5, 1992 on Bringing the Privatization of State and Municipal Enterprises in Moscow in Conformity with the State Privatization Program, Statute on the City and District Commissions on Privatization in Moscow, Statute on Close Subscription to Shares at the Privatization of State and Municipal Enterprises, Program on Privatization of State and Municipal Enterprises in Moscow in 1992, July 31, 1992, *KOMMERSANT*, Aug. 3-10, 1992, at 21-22 [hereinafter Moscow Program].

81. See *supra* Part III.G. for a discussion of Option Two.

that enterprises will be sold by the Property Fund, which conforms with article 6 of the Federal Program. The Program generally follows the 1992 Russian Federation Program, but there are four exceptions.

First, in order to increase the financial capability of potential investors, the Moscow Program provides for the implementation of "banking pledges," which will allow the owner of immovable property to acquire credit from a financial institution by mortgaging the property.⁸² Given the uncertainties in the Russian economy, however, mortgaging property may be judged an unacceptable risk by many investors.

Second, there are substantial differences in the provisions for appraisal. According to the Moscow Program, point 5(1)(2), the historical cost is increased by a number of coefficients that are not specifically defined in the program, but are likely to substantially increase the initial auction price. One may speculate that they will be connected with city zoning, but so far no additional instructions have been issued as to how such coefficients will be applied. In addition, point 5(1)(5) of the Moscow program provides that some very valuable enterprises may be appraised directly in foreign currency, which would be converted to rubles at the date of sale. Obviously, this is one possible response to the problem of inflation.

The third difference applies to buyouts of leased property, which are limited in the Moscow Program to commerce, services and restaurants.⁸³ The Federation Program does not contain such limitations.⁸⁴

The fourth major difference applies to foreign investment. The Moscow Program, in a provision similar to that of the Federation Program with regard to small businesses,⁸⁵ specifies that foreign investment in commerce, services and restaurants is subject to approval from the Moscow Property Committee. Such permission, however, is not required for downtown Moscow enterprises.⁸⁶

82. Moscow Program, *supra* note 80, point 4.

83. *Id.* *supra* note 80, point 10.5. This category is comprised of contracts concluded according to the provisions of the Law on Enterprises and Entrepreneurial activity, which provides that employees may form a company that leases and buys out the existing enterprise.

84. For a discussion of the buyout of leased property under the Federation Program, see *supra* notes 38-39 and accompanying text.

85. See *supra* Part III.I. for a discussion of the Federation Program's provision on small businesses.

86. Moscow Program, *supra* note 80, point 10.5.

VII. CONCLUSION

Although surrounded by a great deal of controversy and opposition within the country, the Russian privatization program is under way and is producing results. The success of the reform as a whole will depend on its implementation during the next few years, after privatization vouchers are distributed and tested in market conditions. For the time being there is substantial uncertainty about the real value of a voucher and whether its face value is indeed backed by real state funds or is just speculative. In order to maintain the public's faith in the voucher and to increase its appeal, the Russian government has initiated plans to "extend the zone of action" of the vouchers by including apartments, houses and land plots in the privatization process. This decision corresponds to the priority needs of the majority of Russian citizens, who are mainly concerned with satisfying basic needs rather than becoming Western style entrepreneurs. In the meantime, it is clear that only after the establishment of a real securities market and after Mutual Funds begin operating on a large scale will an adequate supply and demand mechanism be created.

In general, the West has been slow to invest in the Russian economy. According to Russian estimates, so far only about \$1 billion has been invested,⁸⁷ and only \$13 billion has been disbursed from the \$24 billion promised by the G-7.⁸⁸ Among the major concerns for foreign investors, political instability, problems with foreign debt servicing, bureaucracy, corruption, and legal uncertainty are the most obvious. In addition, investors must be concerned with the monetary policy of the Central Bank of Russia, currency regulation, labor and environmental law regulations, and enterprise indebtedness.

Although the process of privatization in Russia may well seem chaotic, risky, and unpredictable, even the most skeptical observer can not deny the unprecedented scope of the reforms and the far reaching legal changes introduced by President Yeltsin and his advisers. The leaders of the reform are working under constant political pressure, and the tasks to be accomplished in order to make this process irreversible are numerous. It is important, therefore, to note that the stakes for the future of Russia are enormous. In order to give reformers a chance, increased and intelligent cooperation from the West will be needed.

87. *Problems Slow Western Investments*, F.B.I.S., Jan. 15, 1993, at 48.

88. *Aid to Russia*, WASH. POST, Apr. 3, 1993, at A18.