

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

Daniel J. Rothstein
Partner, McDermott, Will & Emery (Moscow)
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

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

Daniel J. Rothstein
Partner
McDermott, Will & Emery
(Moscow)

September 17, 1997

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

Daniel J. Rothstein
Partner
McDermott, Will & Emery
(Moscow)
September 17, 1997

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.