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Policy Memo

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The End of “Primitive Capitalist Accumulation”? The New Bankruptcy Law and the Political Assertiveness of Russian Big Business

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One of the important long-term trends in Russian business since the collapse of the Soviet Union has been concentration, as a small number of business groups (the heads of which are often termed oligarchs) have increasingly brought the country’s most significant firms under their control. These big business groups, many argue, have reached a crucial transition in their attitude to law. Weak legality and fragile property rights facilitated the acquisitions key to empire building. Now these empires have reached their limit—further expansion could occur only through costly struggles among the business titans themselves. To the extent that they are focusing on maintenance and restructuring holdings rather than new acquisitions, business groups now prefer strong property rights rather than weak ones. On this view, the recent wave of pro-business legislation in Russia reflects not a newfound political will to carry out unpopular reforms, but shifting business interests. So-called primitive capitalist accumulation has ended, and the new class of property holders hopes to use law to consolidate its position.

There is much truth to this argument. To understand the character of the legal shifts now underway, however, it is important to realize that the notion of property rights is quite general. *Recent legal changes are aimed at stabilizing the particular conflation of ownership and control characteristic of Russian corporations.* Russia’s industrial firms, with little exception, are controlled by management-level insiders, who hold substantial shares of outstanding stock. Insider-managers have held stock not in order to realize capital gains, but as a way of defending against hostile takeovers. However, even fairly large stock holdings have not served as an effective defense against such takeovers, due to legislation intended to ensure the rights of creditors and minority shareholders. In practice, these guarantees for outsiders have been made to serve the goal of replacing one set of insider owners with another. Recent changes, including new legislation on bankruptcy and commercial court procedures, weaken the rights of creditors and minority shareholders and bolster those of insider owners. The lobbying group representing Russia’s largest business, the Russian Union of Entrepreneurs and Industrials (RSPP by its Russian acronym), worked hard to promote these changes. This suggests that their interests are indeed shifting from acquisition to retention of effective ownership—but this will happen on the basis of stronger property rights for insider owners, rather than other potential claimants. This is likely to be an enduring feature of the Russian corporate governance system.

The first section of this memo describes how Russia’s privatization policies entrenched insider owners and served to conflate ownership control. The second section discusses how

legislation—especially the bankruptcy law of 1998—served as a means of replacing entrenched insiders. The third section discusses recent legal changes meant to strengthen insiders. The conclusion draws implications about prospects for the rule of law in Russia.

Mass Privatization and Undervalued, Insider-Dominated Firms

Most Russian industrial, retail, and wholesale firms were privatized from 1992-1995. With a few significant exceptions—including some of the country's most valuable export-oriented industrial assets—most of the stock was distributed to firm insiders. Although both managers and workers were eligible to acquire stock slated for insiders, managers had advantages in the process, due to their ability to arrange funds to buy the vouchers on which privatization was based. Stock acquisitions by management were defensive in purpose, and not the basis of their control. By and large, managers continued to enjoy a personalistic, substantially unconstrained power over their enterprises, a power that gave the less scrupulous opportunities to enrich themselves at their firm's expense. Corporate governance law was both weak and substantially untested, so even when outsiders could acquire stock shares, turning these into an effective voice in running the corporation was a severe challenge. Investors were reluctant to pay high prices for such a dubious asset. Even after fairly reliable stock trading mechanisms emerged, the Russian corporate sector remained enormously undervalued by the standards of comparable foreign firms—even during the best of times.

The flip side of the argument that low corporate valuations reflected poor corporate governance was that many firms were more valuable to their insider managers than to the stock-buying public. Thus, manager-owners had no incentive to sell shares they had acquired. What they could realize for this stock at market prices was less than the value of their control. Indeed, managers went to some length to try to prevent outsiders from buying any stock at all, also depressing firm valuations.

Thus, the most common outcome of privatization in Russian industry was substantial stock holdings in management's hands with no reason to part with it at prevailing stock market prices.

The Secondary Debt Market as a Surrogate Ownership Market

If insiders were unwilling to sell, how could outsiders acquire the firm? Buying out the insiders would imply paying the whole value of the firm for just a part of the stock—with no guarantee that new owners would acquire with the stock the informal status that had given the former insiders such control. Those intent on industrial acquisitions—especially the largest Russian business groups, which had benefited from the notorious lowball privatization of Russia's most valuable industries—found pursuing them through stock purchasing very difficult. Insiders wouldn't sell the stock needed to give the kind of unassailable dominance over the corporation needed to lever insiders out.

Acquisition specialists found a solution in the largely informal secondary debt market. Would-be acquirers bought up the outstanding loans of a target firm from its creditors. Because they were not entrenched insiders, creditors were willing to sell. Acquirers then used the court system to try to enforce these debts in a way that would give them control over the assets of the target—ideally, by compensating debts with undervalued stock, though the mechanisms were many. Thus, these were debt-for-equity hostile takeovers.

Because assets were the target, creditors often sought ways to prevent targeted debtors from paying off their outstanding obligations, because this would leave the creditor with only money and not the more valuable assets. Legal provisions designed to protect minority shareholders—by giving them the right to challenge certain company decisions—were one way that hostile acquirers could prevent loan repayment from taking place. Another was to push the target firm into bankruptcy proceedings, run by a court-appointed administrator, who could often be convinced to interfere with the repayment of debts that had led to the bankruptcy in the first place.

These legal loopholes allowing forced debt-for-equity exchanges created an entire bankruptcy industry, devoted to facilitating hostile takeovers. These became a key basis for the rapid expansions of the biggest business groups after the August 1998 crisis, a time when high export commodity prices and weak domestic ones gave these groups an especially strong position. These takeovers were sometimes quite hostile, indeed. The high stakes attached to various legal events—such as payment or nonpayment of debt—created strong incentives to contest them. Sometimes, as these contests were pursued in different jurisdictions, conflicting rulings would be issued, creating a situation of multiple legal realities, often degenerating into physical confrontation as different parties tried to enforce their version of the legal facts.

New Legislation: Stronger Owner-Managers, Weaker Outsiders

This fall, Russia passed new legislation weakening the rights of creditors and minority shareholders, while strengthening those of owner-managers. The bankruptcy code, in particular, contains many provisions designed to hinder forced debt-for-equity exchanges. Thus, creditors are forced to try vigorous measures to collect debts before they can initiate bankruptcy proceedings, and a firm in bankruptcy proceedings can always exit them by repaying its outstanding debts. Furthermore, management and the creditors must jointly agree on the bankruptcy administrator, from a list proposed by an independent association of qualified administrators, making it less likely that the administrator will be willing to shift assets from management. Related legislation regulating commercial courts now makes it harder for minority shareholders to interfere with management decisions than it has been previously.

These provisions were the source of heated disagreement; it was the RSPP, whose leadership consists of firms that specialize in debt-for-equity takeovers, that contributed the most to the form they now take. Initial proposals of the government were closer to the pro-creditor version of bankruptcy law passed in 1998. After vigorous public complaints by the RSPP leadership, Parliament passed a version somewhat more favorable to owners. Nevertheless, the RSPP supported Putin's veto of the initial version of the bill, passed by Parliament in the summer, driven in part by loopholes the bill continued to leave open that might prevent firms from paying their debts when they were able to do so.

Implications

The passage of the bankruptcy law, and the manner in which it occurred, suggest several provocative conclusions about the character of politics and legality in Putin's Russia:

- *Outlines of the Russian model of capitalism.* One of the striking features of capitalist economies elsewhere in the world is the extent to which their institutions vary. American and

French bankruptcy legislation, for instance, is heavily focused on preserving firms, whereas British and German legislation give greater weight to creditor interests. When the 1998 bankruptcy law was adopted, it followed the latter models more closely, which heartened those who felt the Russian economy's major problem was soft-budget constraints. When the idea of creditor protection was inserted into a context of struggles to dislodge enterprise insiders, however, it took on a very different meaning. The new law, because it is more favorable to management and going concerns, appears well adapted to stabilizing big business' consolidation on the basis of a conflation of ownership and control.

- *Toward a law-governed economy?* Russian elites appear to be in quite general agreement that the 1998 bankruptcy law fostered contentious and, at times, violent confrontations over ownership and control. Yet, if this argument is accurate, the stereotype of Russia's economy as lawless and arbitrary is overdrawn. The problem was bad law, not the irrelevance of law per se, and better law should resolve it. If confrontations of ownership and control of corporations do subside, this conclusion will gain new weight. However, much work would remain to be done to explore the boundaries between law-governed and extralegal mechanisms in regulating business practice.
- *The emergence of effective corporate representation for big business.* The RSPP, long moribund before energized by the decision of Russia's biggest business leaders to join it, now regularly weighs in with research and proposals on all major legislation affecting business. It does not always have its way—last year, for instance, it failed to push pension reform as far toward privatization as it wished. However, the coalescence of an important form of lobbying focused on law is a significant development in its own right. The RSPP was not the only important interest group affected by this legislation—professional organizations of turn-around specialists as well as the state agency responsible for regulating bankruptcy were also major players in the legislative debate. This suggests that the locus of politics is moving outside the executive branch, despite the manifest constraints Putin's government has sought to put on the contours of public debate. Significant economic issues are being contended in the public arena and perhaps, even decided there.