

**Nothing Quiet on the Eastern Front:  
Troubling Developments in the Russian Market for Corporate Control**

Geoffrey Christopher Rapp\*

“The root of all was a friendly loan.”<sup>1</sup>

This Article discusses the policy ramifications of a troubling recent development in Russian corporations law. In April 2001, Gazprom,<sup>2</sup> one of Russia’s largest industrial conglomerates, effected a hostile takeover of the television station NTV.<sup>3</sup> What makes this hostile takeover novel and troubling is that rather than make a public offer for NTV shares, as contemplated in Russia’s Joint-Stock Company Law,<sup>4</sup> Gazprom took control by purchasing NTV’s defaulted debt and exercising creditors’ rights. This Article suggests that such an

---

\* Adjunct Professor, Wayne State University Law School, Detroit MI; J.D., Yale Law School; A.B. (Economics), Harvard University. Special thanks to Curtis Doty at the London office of Herbert Smith; Professor Ian Ayres of the Yale Law School; and Professor Henry Hansmann, also of Yale. Shannon Selden, of the New York office of Debevoise and Plimpton, and Ilyana Kuziemko, of the Department of Mathematics at Oxford University, provided excellent commentary of drafts of this Article. In addition, the author wishes to dedicate this Article to the many toiling Russians who met in Magadan, Moscow, and St. Petersburg in the summer of 1993. All errors are my own.

<sup>1</sup> HERMAN MELVILLE, *THE CONFIDENCE-MAN* 228 (1954).

<sup>2</sup> Gazprom is the largest national gas supplier in the world. See David R. Sands, *NTV’s Hostile Takeover Blasted; Federov Criticizes Gazprom’s Move*, WASH. TIMES, April 19, 2001, at A11. The Russian government remains its largest shareholder, controlling 38.3% of its stock. See *id.* The company by itself accounts for seven percent of Russia’s GDP and a fifth of the government’s tax base. See *id.*

<sup>3</sup> Vladimir Gusinsky, whose grandfather was executed in Stalin’s 1937 purge and whose grandmother was imprisoned in Siberia, founded NTV in 1993, see CHRYSTIA FREELAND, *SALE OF THE CENTURY* 137 et seq. (2000), along with Igor Malashenko, Oleg Dobrodeev and Evgenii Kiselev who left *Ostankino*, the state television station. See U.S. AGENCY FOR INT’L DEVELOPMENT, *A SURVEY OF RUSSIAN TELEVISION*, <http://www.internews.ru/report/tv/tv52.html> (last visited May 16, 2001) [hereinafter USAID]. “NTV” is the Russian acronym for “independent television.” See *id.* at 145. The station’s programming is available in Europe and Russia through channel 4 microwave infrastructure, and in parts of Kazakhstan, Belarus, the Baltics and Ukraine. See USAID, *supra*. Its flagship news show, *Segodnya* (“Today”), and its weekly commentary program, *Itogi* (“Results”), regularly beat state programs in viewership. See *id.*

<sup>4</sup> See Ob Aktsionernykh Obschestvakh RF [Federal Law of the Russian Federation on Joint-Stock Companies], RF Federal Act NO. 208-FZ, Dec. 26, 1995 [hereinafter Russian Company Law].

approach to takeovers, should it become more common, poses a significant danger to the nascent market for corporate control in the former Soviet Union.

While this Article is primarily a policy analysis of emerging trends in Russian takeover law, along the way the story of Gazprom provides a rich and textured narrative, with characters ranging from iron-fisted titans of industry, to protesting masses in Moscow streets, to armed operatives of the former KGB, to the last leader of the Soviet Union, Michael Gorbachev.<sup>5</sup>

In Part I of the Article, I briefly describe the history of the current corporations law in Russia. The law, designed by two American law professors to be “self-enforcing,”<sup>6</sup> has been the victim of cronyism and corruption and has not achieved its goals. In Part II of the Article, I describe the central provisions of the corporate governance sections of that law. These sections provide the framework by which the law’s drafters envisioned corporate control would change hands, and it is against this ideal scheme that the painful realities of the Gazprom takeover of NTV must be judged. In Part III, I describe the contours of the Gazprom takeover of NTV, and in Part IV, I highlight the negative policy consequences of deals of this nature. Finally, in Part VI, I conclude.

This Article aims to contribute to the emerging thread of literature in the legal academy<sup>7</sup> that evaluates the effects of the largely American-lawyer-led effort<sup>8</sup> to reform Russia’s economy.<sup>9</sup> While previous scholarly work has suggested that the corporate governance regime in Russia

---

<sup>5</sup> See *infra* Part III.

<sup>6</sup> See Gregory Wolk, *Corporate Governance Reform in Russia: The Effectiveness of the 1996 Russian Company Law*, 8 PACIFIC RIM L. & POL’Y REV. 219, 220 (1999) (“The law . . . is a modified version of a proposed law designed by . . . Black and . . . Kraakman.”).

<sup>7</sup> The last four decades of Soviet law, and law in the emerging Russian federation, were “followed by western students closely and with fascination.” W.E. BUTLER, *RUSSIAN LAW* 6 (1999).

<sup>8</sup> The American Bar Association’s Central and Eastern European Law Initiative (CEELI) has provided intense support to lawyers and policy-makers in the Russian federation, both by writing and evaluating draft laws and by training Russian lawyers. See CENTRAL AND EASTERN EUROPEAN LAW INITIATIVE, AMERICAN BAR ASSOCIATION, 1998 ANNUAL REPORT, available at <http://www.abanet.org/ceeli/> (last visited May 13, 2001).

<sup>9</sup> See, e.g., Bernard Black et al., *Russian Privatisation and Corporate Governance: What Went Wrong?*, 52 STAN. L. REV. 1731 (2000).

failed largely because of hostile external conditions such as a bad business climate and macroeconomic instability,<sup>10</sup> this Article and the case study it pursues<sup>11</sup> suggest that loopholes in the Act itself can cause serious problems for the Russian market for corporate control. With regard to the Russian economy, “problems in corporate governance often are mentioned . . . but [are] little analysed.”<sup>12</sup>

At the same time as it contributes to this scholarly debate, however, this Article will not neglect the real-world significance of rationalizing Russian corporate law. In developed countries, corporate law “plays a small, even ‘trivial’ role”<sup>13</sup> in regulating economic activity because of other legal, market and cultural constraints on corporate behaviour.<sup>14</sup> In developing countries like modern-day Russia, in contrast, “these other constraints are weak or absent, so corporate law is a much more central tool for motivating managers and large shareholders to

---

<sup>10</sup> *See id.* (“In a mythical thick market for corporate control, good owners could buy companies from bad owners if a company was worth more if run honestly than if run to maximize short-run skimming. But in fact, good owners don’t exist in Russia in significant numbers or with the capital to buy large enterprises. If they existed, they wouldn’t pay a bad owner anything close to fair value, because they couldn’t verify what shape the business was in. Moreover, the business might be worth more to the bad owner, who has a comparative advantage in the important tasks of self-dealing, evading taxes, obtaining favours from the government, not paying workers, and using effective albeit unofficial means (read: the Mafia) to enforce contracts and scare off competitors.”).

It is of course true that these problems exist in Russia. Macroeconomic instability and lacklustre growth have doomed many business ventures. Russia’s per capita gross domestic product has fallen 40 percent since 1992; it now stands at only 15% of the US level; unemployment tops 12 percent. *See* MCKINSEY GLOBAL INSTITUTE, UNLOCKING RUSSIAN ECONOMIC GROWTH (1999), <http://mgi.mckinsey.com/mgi/russian.asp> (last visited May 15, 2001).

<sup>11</sup> While the case study approach suffers from inherent selection bias, such studies can “present a reasonably coherent picture of the landscape of corporate governance failures.” Merritt B. Fox & Michael A. Heller, *Corporate Governance Lessons From Russian Enterprise Fiascoes*, 75 N.Y.U.L. REV. 1720, 1727 (2000).

<sup>12</sup> *See id.* at 1727.

<sup>13</sup> *See* Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 HARV. L. REV. 1911, 1914 (1996).

<sup>14</sup> Of course, securities laws continue to impose substantial costs on companies in developed nations. *See* Geoffrey Christopher Rapp, *Proving Markets Inefficient*, UNIV. OF MIAMI BUS. L. REV. (forthcoming spring 2002) (describing effects of US Securities laws on business activity); Geoffrey Christopher Rapp, *Advanced Economic Development, International Trade, and Farmers: Is the New Global Economy Bad News for Agricultural Workers?*, 5 DRAKE J. OF AGRICULTURAL L. 472 (2000) (describing effect of Japanese regulatory regime on the Japanese economy and business activity).

create social value rather than simply transfer wealth to themselves from others.”<sup>15</sup> Given the powerful effect of domestic laws on foreign investment,<sup>16</sup> the need for strong legal regimes in cash-poor Russia<sup>17</sup> is intense.

## I. A SHORT HISTORY OF POST-SOVIET CORPORATE LAW

Before the fall of the Iron Curtain, economic activity was far and away the most heavily regulated area of Soviet society.<sup>18</sup> In the earliest days of Bolshevik ascendance, Soviet policy-makers had little opportunity to reflect upon the role of law in a socialized economy.<sup>19</sup> Some held naïve notions about the rapid withering-away of legal and economic institutions,<sup>20</sup> while others made a more nuanced argument for the prompt elimination of Roman legal concepts.<sup>21</sup> In 1931, in conjunction with its economic program, the Soviet leadership conferred the essential attributes of legal personality to business entities.<sup>22</sup> Bureaucracies seized control of the economy, however, with the onset of the Second World War.<sup>23</sup> In autumn, 1965, Soviet leadership enacted a series of decrees intended to stimulate economic growth by enhancing, among other things, the legal autonomy of enterprises.<sup>24</sup> *Perestroika* reforms enacted in 1987 further enhanced the power and autonomy of enterprises.<sup>25</sup> The story of corporate law in post-Soviet Russia stars two American law professors: Bernard Black, of Stanford University, and Reinier Kraakman, of Harvard

---

<sup>15</sup> Black & Kraakman, *supra* note 13, at 1914.

<sup>16</sup> See Ilyana M. Kuziemko & Geoffrey Christopher Rapp, India’s Wayward Children: Are Affirmative Action Laws to Blame for Low Levels of Foreign Direct Investment by the Indian Diaspora?, 10 MINN. J. GLOBAL TRADE 323 (2001).

<sup>17</sup> See Greg Lumelsky, *Does Russia Need a Securities Law?*, 18 J. INT’L L. BUS. 111, 118 (1997).

<sup>18</sup> See W.E. BUTLER, SOVIET LAW 242 (1988) (“The quantity of legislation regulating the national economy in the Soviet Union is stupendous by any standard. It would not be implausible to say that the total number of normative acts at all levels concerned with socialist economic relations exceeds all other normative acts together.”).

<sup>19</sup> *See id.*

<sup>20</sup> *See id.*

<sup>21</sup> *See id.* at 243.

<sup>22</sup> *See id.* at 244.

<sup>23</sup> *See id.* at 245.

<sup>24</sup> *See id.* at 245.

University.<sup>26</sup> In 1994 and 1995, these two scholars crafted the Russian Joint-Stock Company Law, designed to govern the privatisation of Russia's state-dominated economy and, subsequently, to guide the interaction of business enterprises.<sup>27</sup> Professors Black and Kraakman designed the law to enforce itself: that is, "through actions by direct participants in the corporate enterprise . . . rather than indirect participants."<sup>28</sup>

The Joint-Stock Company Act contains a number of provisions that should be familiar to the western student of corporations law: companies created under the Act are governed by their charters;<sup>29</sup> shareholders have limited liability;<sup>30</sup> annual meetings must be held and annual reports published;<sup>31</sup> shares are openly tradable;<sup>32</sup> and there are minimum capitalization requirements.<sup>33</sup>

Even according to the Act's authors, however, the privatisation components of the Act were a massive failure: privatisation led to insider self-dealing on an unheralded scale, a hostile business environment swamped profit incentives to restructure privatised enterprises (instead of looting them), and corrupt privatisation of large firms compromised subsequent reforms.<sup>34</sup>

In 1996, Russia also enacted a securities law, with disclosure provisions largely modeled on the American securities regime.<sup>35</sup>

---

<sup>25</sup> *See id.* at 260.

<sup>26</sup> *See generally* Black & Kraakman, *supra* note 13.

<sup>27</sup> The law codified the most popular Russian organization-legal form, the joint-stock society, widely known by the Russian acronym ZAO, a form known in Russia since the eighteenth century. *See* BUTLER, RUSSIAN LAW, *supra* note 7, at 425.

<sup>28</sup> *See* Black & Kraakman, *supra* note 13, at 1916.

<sup>29</sup> *See* David Cant & Harris Rosenberg, Russia: Market Approaches: The Definitive Business Digest 18 (1994) [hereinafter Market Approaches].

<sup>30</sup> *See id.*

<sup>31</sup> *See id.*

<sup>32</sup> *See id.*

<sup>33</sup> *See id.* The minimum capitalization requirement for an open joint-stock company is 1000 times the minimum amount of payment for labour. *See* BUTLER, RUSSIAN LAW, *supra* note 7, at 427.

<sup>34</sup> *See* Black et al., *supra* note 9, at 1732-33.

<sup>35</sup> *See generally* Lumelsky, *supra* note 17.

## II. COMPANY ACT PROVISIONS CONCERNING CORPORATE CONTROL

The Company Act's authors envisioned that control transactions would include "open market purchases and tender offers, and large share issues by companies in the course of financings or mergers."<sup>36</sup>

As in most western countries, Russian shareholders were to receive put and call options triggered by certain specified corporate actions: appraisal rights for shareholders who do not approve major transactions, and takeout rights when a controlling stake in the firm is acquired (a right on the part of minority shareholders to sell their shares to the new controlling shareholder).<sup>37</sup> The professors also proposed that major transactions require a super majority of two-thirds of the outstanding shares,<sup>38</sup> and the Duma subsequently raised that figure to 75%.<sup>39</sup> The professors suggested that a merger or other business combination, a liquidation, a transformation of the company into another business entity, and a sale of assets with a book value of more than 50% of the company's assets would constitute "major transactions."<sup>40</sup>

Aware of the risk of "secret" attempts to acquire control, the professors also drafted a disclosure-and-wait requirement that shareholders who obtain more than 15% of a company's stock publicly disclose their identity, shareholdings, and plans to acquire more shares, and then wait thirty days before buying more shares.<sup>41</sup> Deals between 25% and 50% require unanimous board approval or the consent of a majority of shareholders.<sup>42</sup>

---

<sup>36</sup> See Black & Kraakman, *supra* note 13, at 1960.

<sup>37</sup> See Black & Kraakman, *supra* note 13, at 1917.

<sup>38</sup> See Black & Kraakman, *supra* note 13.

<sup>39</sup> See Russian Company Law, *supra* note 4, art. 79.

<sup>40</sup> See Black & Kraakman, *supra* note 13, at 1954.

<sup>41</sup> See Black & Kraakman, *supra* note 13, at 1962.

<sup>42</sup> See Russian Company Law, *supra* note 4, art. 40.

### III. THE TAKEOVER OF NTV

NTV was the flagship asset of Vladimir Gusinsky, a Russian “oligarch” who controlled a veritable empire through his Media-Most group.<sup>43</sup> Some speculated that the merger was motivated by political forces, as Gusinsky and his group have been outspoken critics of the conduct of Russian president Vladimir Putin’s in the breakaway Republic of Chechnya.<sup>44</sup> While critics of the move have charged that the takeover will limit the nascent free press in Russia and thus undermine the country’s civil society,<sup>45</sup> this Article focuses exclusively on the policy consequences of the structure of the deal itself, rather than the effects the loss of NTV’s independence may have on Russia’s media industry.

Unlike most takeovers, in which shareholders are bought out by suitors, the takeover of NTV was affected through the vehicle of creditors’ rights. For years, Gazprom generously extended credits to NTV,<sup>46</sup> its loans<sup>47</sup> and loan guarantees amounting to hundreds of millions of dollars.<sup>48</sup> By chasing its loans and exercising creditors’ rights, Gazprom was able to take control of the NTV board.<sup>49</sup> Gazprom completed its takeover on April 3, 2001.<sup>50</sup>

---

<sup>43</sup> See Sands, *supra* note 2.

<sup>44</sup> See Sands, *supra* note 2.

<sup>45</sup> See Sands, *supra* note 2.

<sup>46</sup> See Mark Franchetti, *Putin’s TV Takeover Silences Critics*, SUNDAY TIMES (London), April 15, 2001. NTV spent cash as fast as it came in. In its first fifteen months of existence, the company burned \$30 million of Gusinsky’s money. See FREELAND, *supra* note 3, at 145.

<sup>47</sup> In 1996, Gazprom provided NTV a \$40 million loan on favourable terms. See FREELAND, *supra* note 3, at 230.

<sup>48</sup> See Henry Meyer, *Fears for Russia’s Media Freedom as TV Station Faces State Takeover*, AGENCY FR. PRESSE, April 2, 2001. In particular, Gazprom guaranteed \$211 million NTV borrowed from Credit Suisse First Boston in March 1998 and \$261 million in July 1998 at 19.5% interest. See Anna Raff, *No Happy Ending for NTV*, THE MOSCOW TIMES, April 23, 2001. When NTV clashed with the Kremlin over the war in Chechnya, banks began to fear that Media-Most was no longer credit-worthy and refused to extend further loans. See FREELAND, *supra* note 3, at 158.

<sup>49</sup> See Franchetti, *supra* note 46. Notable members of the governance structure of NTV include Michael Gorbachev, architect of the *glasnost* (“openness”) and *perestroika* (“restructuring”) reforms of the late 1980s. See Meyer, *supra* note 48.

<sup>50</sup> See *Russian Duma to Discuss Bills Restricting Foreign Stakes in Media Cos April 25*, AFX NEWS SERV., April 10, 2001.

The precise mechanics of the deal are somewhat ambiguous. NTV had pledged assets to Gazprom in order to finance the expansion of the television company.<sup>51</sup> Gazprom, which owned 46 percent of NTV's parent group, Media-Most,<sup>52</sup> called a shareholders' meeting in order to collect its loans.<sup>53</sup> Media-Most had previously pursued a deal in which it would sell 19% of its shares to foreign investors, and use the proceeds to pay off its loans (the 19% was put up as collateral for the second CSFB loan).<sup>54</sup> In February, however, a Moscow court struck down that transaction and froze the 19% stake in Media-Most.<sup>55</sup> With those shares frozen and Gusinsky's voting rights thus undercut, Gazprom acquired majority control of the NTV votes. On May 4, 2001, a Russian court handed the 19% stake to Gazprom (as a means of satisfying outstanding debt, the treasury shares having served as collateral), giving Gazprom 65% of the voting shares in NTV.

While thousands of concerned Russian citizens protested the takeover on Moscow's streets,<sup>56</sup> employees of NTV initially refused to vacate their offices. The journalists finally left on April 14 when Gazprom, assisted by gun-toting Interior Ministry forces (formerly the KGB) forcibly occupied the premises.<sup>57</sup> Following the takeover, Gazprom announced that it had appointed Alfred Kokh, the head of its media wing, to run NTV operations.<sup>58</sup> Kokh is best known for overseeing the Kremlin's privatisation program before resigning in 1998 amid allegations of corruption and scandal.<sup>59</sup> He did not get off on the best foot with NTV staff when,

---

<sup>51</sup> See Quentin Peel, *Glasnost to Gazprom*, FIN. TIMES, April 29, 2001.

<sup>52</sup> See Meyer, *supra* note 48.

<sup>53</sup> See *id.*

<sup>54</sup> See Raff, *supra* note 48.

<sup>55</sup> See Meyer, *supra* note 48.

<sup>56</sup> See Michael Wines, *TV Takeover Stirrs Protest in Moscow*, N.Y. TIMES, April 8, 2001, at 15.

<sup>57</sup> See Moscow Court to Examine Appeal Against NTV Takeover, AGENCY FR. PRESSE, May 10, 2001.

<sup>58</sup> See Franchetti, *supra* note 46.

<sup>59</sup> See *id.*



in his first week on the job, he sent them an open letter concluding with a line from his favourite film, the Godfather: “With your insults you are offending my intelligence.”<sup>60</sup>

Disgruntled shareholders of NTV complained to the Moscow Arbitration Court,<sup>61</sup> arguing that the April 3 shareholder meeting that resulted in Gazprom’s control of the board had been illegal.<sup>62</sup> The court initially promised a response in early May, but subsequently postponed its decision until September.<sup>63</sup>

By assuming control through the exertion of creditors’ rights, Gazprom effectively circumvented Russia’s Company Act. Because the seizure of the 19% of NTV held as collateral in the second CSFB loan amounted to less than 50% of the assets of NTV, no super-majority vote was required. Therefore, with its existing holdings of NTV stock and the assistance of a small firm that held a five percent stake, Gazprom was able to take control of the board. Although the company would have had to disclose under the 15% guideline, this amounts to too-little-too-late, since Gazprom already had firm control of the station. Because the transfer involved an asset shift, no appraisal rights were granted to disgruntled shareholders.

#### IV. POLICY IMPLICATIONS

Because NTV was not actually in bankruptcy proceedings, the secured lending law governing claim priority did not take effect.<sup>64</sup> Similarly, the Arbitration Court did not have to

---

<sup>60</sup> *See id.*

<sup>61</sup> This is the Arbitrazh court, translated as “arbitration court” by some, *see* Paul H. Rubin, *Growing a Legal System in the Post-Communist Economies*, 27 CORNELL INT’L L.J. 1 (1994), and as “arbitrage courts” by others, *see* Black & Kraakman, *supra* note 13, at 1911. The system of Arbitrazh courts predates the fall of the Soviet Union, having been created in 1931 to resolve conflicts over economic contracts. *See* BUTLER, SOVIET LAW, *supra* note 18, at 121-22.

<sup>62</sup> *See Moscow Courts Postpones Appeal Against NTV Takeover Until September*, AGENCY FR. PRESSE, May 10, 2001.

<sup>63</sup> *See id.*

<sup>64</sup> In Russia, bankruptcy law does not function at all. Secured lending is crippled by a Civil Code provision that gives secured lenders third priority in insolvency proceedings, after personal injury claims and employee claims. *See* Black & Kraakman, *supra* note 13, at 1968. In 1998, Russia enacted a new law on insolvency, *see* William P. Kratzke, *Russia’s Intractable Economic Problems and the Next Steps in Legal Reform: Bankruptcy and the De-politicisation of*

pass on the deal before its completion. Playing the role of “vulture,”<sup>65</sup> Gazprom evaded the major anti-takeover provisions of Russian law. Given the attention in Russia focused on the deal, there is no doubt that its reverberations will have lasting policy ramifications across the Russian economic landscape.

#### A. INCENTIVE FOR FIRMS TO AVOID FINANCING THROUGH DEBT

The first negative implication of the creditors’-rights-style takeover in which Gazprom engaged is that it will be widely observed in the former Soviet Union and may deter potential target corporations from financing through debt. Ordinarily, a firm attempts to strike a balance between debt and equity financing so as to minimize the agency costs that arise from the separation of ownership and control.<sup>66</sup> Russian firms may now avoid debt financing as a means of preserving their existing control regimes. By financing primarily or exclusively through equity offerings, such firms will remain under the protection of the Russian Company Act.

The inefficiency associated with such a result is obvious. Debt financing has been demonstrated to discipline lackadaisical corporate leadership<sup>67</sup> and stimulate managers to restructure corporations so as to concentrate energies on core competencies and profit centres.<sup>68</sup> Because firms must periodically obtain cash to service their debt, they must focus on having

---

*Business*, 21 J. INT’L BUS. 1, 33 (2000). Nevertheless, this law did not apply because, with the 19% shares held as collateral, NTV was able to satisfy its obligations and had not entered bankruptcy.

<sup>65</sup> In the United States, some “vulture funds” purchase large shares of defaulted debt in order to have a seat at the table in restructurings directed by federal bankruptcy courts. See Bernard S. Black, *Shareholder Passivity Re-examined*, 89 MICH. L. REV. 520, 574 (1990).

<sup>66</sup> See HENRY HANSMANN, *THE STRUCTURE OF ORGANIZATIONAL LAW* (1996). “Entrenched managers, employing conservative fiscal policy, make suboptimal investment to suit their own interests rather than those of their principles. . . . [L]everage facilitates restructuring.” See William W. Bratton, *Fundamental Corporate Law Changes: Causes, Effects, and Legal Responses: Corporate Debt Relationships: Legal Theory in a Time of Restructuring*, 1989 DUKE L.J. 92, 166 (1989).

<sup>67</sup> See WALTER NOVAES & LUIGI ZINGALES, *CAPITAL STRUCTURE CHOICE WHEN MANAGERS ARE IN CONTROL: ENTRENCHMENT VERSUS EFFICIENCY* (Nat’l Bureau of Econ. Research, Working Paper No. W5384, 1995), available at <http://papers.nber.org/papers/W5384>.

positive returns. Absent this stimulus, managers might instead allow payrolls and expenses to bloat. With Russian company's notorious inefficiency, the need to preserve debt financing as a tool of corporate control is urgent.<sup>69</sup>

## **B. FAILING TO PROVIDE A MARKET THAT OFFERS SUITABLE PREMIUMS TO SHAREHOLDERS**

In the theoretical market for corporate control, changes of control lead to more efficient use of assets. Therefore, corporations law scholars persistently argue that only minimal defensive behaviour should be permitted on the part of target boards.<sup>70</sup> When there is a danger, however, of an acquirer "looting" the assets of a corporation (thereby destroying their value), legal rules should provide room for companies to defend their control.

Gazprom has betrayed an interest in looting the assets of NTV, specifically its broadcast frequencies, for inefficient purposes. Gazprom's General Director, Ryem Vyakhirev, stated, "[Gazprom] has been persistently pilloried [by the press] on various issues, and since we have over a million shareholders, and we need to talk to them, we're looking for ways to communicate, including television."<sup>71</sup> Essentially, then, Gazprom believes it has purchased a public relations vehicle.<sup>72</sup>

Typical mergers, accomplished by open market purchases and tender offers, guard against looting by forcing acquirers to pay a premium to target shareholders as a means of inducing target shareholders to tender their securities. By using creditors' rights rather than a

---

<sup>68</sup> See George G. Triantis, *Debt Financing and Motivation*, 31 U. RICH. L. REV. 1323, 1327 (1997).

<sup>69</sup> Of course, too much debt can be a bad thing for societies. See JAMES MEDOFF & ANDREW HARLESS, *THE INDEBTED SOCIETY* (1998). There is probably an optimal level of debt; the Gazprom takeover threatens to interfere with the achievement of that equilibrium.

<sup>70</sup> See Frank Easterbrook & Daniel Fischel, *The Economic Structure of Corporate Law* 174 (1992).

<sup>71</sup> See USAID, *supra* note 3.

<sup>72</sup> See *id.*

tender offer, Gazprom avoided the need to pay a premium to NTV shareholders.<sup>73</sup> This troubling result means that existing shareholders, including Gusinsky himself, were insufficiently compensated for their holdings. This violates the arguable property right shareholders possess in their assets.<sup>74</sup> Moreover, it might undermine the willingness of foreign investors to participate in Russian equity offerings. As suggested in this paper's introduction, such a result could pose a serious threat to the growth of Russia's market for securities and its economy as a whole.

### C. ENCOURAGES BANKS AND GROUPS TO EXTEND BAD CREDIT

Hostile takeovers through debt purchase induce further distortion to the already strained Russian banking system. This system has been called "dysfunctional,"<sup>75</sup> and Harvard's Jeffrey Sachs once called Central Bank head Viktor Gerashchenko "perhaps the worst central banker in history."<sup>76</sup> At present, Russian commercial banking law does not require the rigid separation between commercial and investment functions required under the Glass-Steagall Act<sup>77</sup> in the United States.<sup>78</sup> As a result, banks, and companies engaged in the quasi-banking function of guaranteeing loans (Gazprom in this instance), have become major players in the purchase of stock in newly privatised companies.

The Gazprom deal has shown banks and guarantors that the protections of the Joint-Stock

---

<sup>73</sup> To some degree, the problem described here is similar to the coercive nature of a tender offer made for defaulted debt, a practice growing more common in the United States. A company makes a bid on the open market for its own defaulted high-yield bonds, at a price above the market value but well below the face value of the bonds. Legal commentators have noted the problems takeovers of this kind pose for shareholder rights. See, e.g., Andrew Lawrence Bab, *Debt Tender Offer Techniques and the Problem of Coercion*, 91 COLUM. L. REV. 846, 849-51 (1991).

<sup>74</sup> See David D. Haddock et al., *Property Rights in Assets and Resistance to Tender Offers*, 73 VA. L. REV. 701 (1987); Lucian Arye Bebchuk, *Toward Undistorted Choice and Equal Treatment in Corporate Takeovers*, 98 HARV. L. REV. 1695 (1985).

<sup>75</sup> See Black et al., *supra* note 9, at 1761.

<sup>76</sup> See *id.*

<sup>77</sup> 12 U.S.C. § 1841 (as amended).

<sup>78</sup> See Lumelsky, *supra* note 17, at 128.

Company Act may be effectively circumvented through the exercise of creditors' rights. Such lenders may now be encouraged to make loans to bad credit risks,<sup>79</sup> in order to obtain control of borrowers' assets and, eventually, their boards. To some degree, this incentive will be counteracted by companies' increasing reluctance to utilize debt financing.<sup>80</sup> Unfortunately, this balance will be imperfect. Good companies with valuable assets and attractive prospects will avoid the credit markets. Bad companies less concerned about hostile takeovers will not. Banks may send loans to such companies in order to gain control of their assets, and this result will lead to widespread loan default among Russian firms. As a consequence, commercial interest rates will rise and it will become even more costly for promising firms to access the capital markets. That will undermine investment, which is singularly important in increasing labour productivity and improving living standards.<sup>81</sup>

## V. CONCLUSION

Previous scholarship on the Russian problem has suggested that "Russia's core problem today is less lack of decent laws than lack of the infrastructure and political will to enforce them."<sup>82</sup> This may very well be true. Yet it should not distract from the fact that loopholes exist in the Russian Company Act that are not helping the situation.

This Article tells the disturbing story of the exploitation of such a loophole by one of Russia's most menacing corporate groups. Gazprom's cynical takeover of NTV neatly dodged

---

<sup>79</sup> An old Russian proverb to some degree anticipates the moral hazard this sort of behaviour represents. Translated roughly, it says:

"Mummy why can't I go swimming in the sea?"

"Because there are sharks in the sea."

"But Mummy, Daddy is swimming in the sea."

"That's different he is insured."

<sup>80</sup> See *infra* Part IV.A.

<sup>81</sup> See WILLIAM C. NORDHAUS, *MACROECONOMICS* (1999).

<sup>82</sup> See Black et al., *supra* note 9, at 1755.

the protective provisions of the takeover guidelines. NTV minority shareholders were stiffed, and the Russian media may never again be the same.

Urgent reform of the 1996 Joint-Stock Company Act is needed to prevent the Gazprom model from being widely applied in hostile takeovers of other Russian business associations. One obvious reform would be to limit the ability of companies to pledge shares as collateral for commercial debt. This would prevent creditors from obtaining the sort of favourable position from which they may easily launch surreptitious hostile takeovers in circumvention of the regulations of the Joint-Company Stock Act. On the other hand, limiting the ability of borrowers to provide security might dry up Russian capital markets to a degree. Well-regarded scholars, however, have questioned whether secured financing is anything more than a zero-sum game, that is, whether permitting security does not increase the overall pool of credit but rather simply shifts credit from one borrower to another.<sup>83</sup> A related approach would be to regulate debt-equity ratios, a tactic that has historically been pursued in the United States.<sup>84</sup>

The Russian courts should also adopt a “substance over form” approach to analysing mergers and related transactions. Because the exercise of creditors’ rights was effectively a takeover, it should have been subject to the takeover guidelines in the 1996 Joint-Stock Company Law. It is unlikely that the Arbitration Court will buck the political power of Gazprom and reverse the takeover of NTV, but such a result should be hoped for and advocated by western leaders.

The relationship between debtor and creditor is meant to and should be contractual, not organizational.<sup>85</sup> Loopholes in the Black and Kraakman law have left Russia’s commercial landscape muddled and allowed creditors and guarantors to seize organic control of newly

---

<sup>83</sup> See Alan Schwartz, *Security Interests and Bankruptcy Priorities: A Review of Current Theories*, 10 J. LEG. STUD. 1, 10 (1981).

<sup>84</sup> See Bratton, *supra* note 66, at 96.

<sup>85</sup> See HANSMANN, *supra* note 66.

privatised firms. It is time for the Duma and the Russian courts to protect the rights of shareholders and induce harmony and rationality in post-Soviet corporate law.