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Roger D. Billings Jr.

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ARTICLES

Why Business Fails in Russia

ROGER D. BILLINGS JR.*

I. Introduction

At the dawn of the twenty-first century, John Browne, the Chairman of BP Amoco PLC, looked back on his company's \$484 million investment in Russian oil. He said, "I've always considered America to be governed by laws, not men. The reverse may be true in Russia."¹ George Soros, whose investment funds lost \$1 billion in Russia, declared the loss "the biggest mistake of my investment career."² Soros and many other investors watched helplessly when the Russian banks crashed during August 1998. During the 1990s, investors entered Russia with money and, with a few exceptions, departed empty-handed. Some even lost money on the stock of GUM department store, which is located on Red Square, and revered by Soviet and post-Soviet shoppers as the premiere store in Russia.³ After the August crash investors watched GUM stock decline to twenty-five cents per share from a high of \$5.40.⁴ It was predictable behavior for the stock of a company whose profits were clearly evaporating. The stock was once highly prized because, unlike many other Russian companies, GUM boasted Western-style management and accounting practices, sales of \$926 per square foot (compared to \$267 for Bloomingdale's in New York), and a 40 percent return on assets.⁵

There are many reasons for the failure of American investments, and one of the important reasons is the lack of an investment-friendly legal system. True, in 1994 the Duma approved the first part of a comprehensive Civil Code that contained rules on enforceability of contracts.⁶ In the early 1990s, a voucher system introduced shareholder ownership of businesses

*Roger D. Billings, Jr. is Professor of Law at Chase College of Law, Northern Kentucky University. Since 1990 he has lectured from time to time in law schools at Kharkiv, Ukraine, and at Kursk, Tambov and Moscow, Russia. He was on sabbatical in 1999 at the Russian Peoples Friendship University, Moscow.

1. Jeanne Whalen & Bhushan Bahree, *How Siberian Oil Turned into a Minefield. BP Amoco Learns Bruising Lesson on Investing in Russia*, WALL ST. J., Feb. 9, 2000, at A21.

2. George Soros, *Breaking the Bank*, WALL ST. J., Dec. 13, 1999, at C1; see also GEORGE SOROS, *THE CRISIS OF GLOBAL CAPITALISM: OPEN SOCIETY ENDANGERED* 152-74 (1998).

3. GUM is an acronym for *Gosudarstviye Universalniye Magazin*, or City General Store.

4. Nicholas D. Kristof & Sherly WuDunn, *Of World Markets, None an Island*, N.Y. TIMES, Feb. 17, 1999, at A1.

5. *Id.* at A8.

6. WILLIAM E. BUTLER, *RUSSIAN LAW* 336 (1999).

and soon a stock market and banking system emerged. A new Constitution had even set up specialized Arbitrazh Courts for businesses to resolve their disputes.⁷ And only one important legal reform remained unfinished: the Communist-dominated Duma refused to adopt laws to facilitate private ownership of land.⁸ This did not deter investors, however, who could effectively control land by acquiring a privatized company. But with the laws that were enacted and all the courts that were in operation, the immaturity of the legal system was an obstacle to business.

Operating as designed, the legal system should have been sufficient to protect investments by foreigners but instead it offered only the appearance of protection. Contracts required precision of drafting and conformance to statutory requirements for various types of contracts. The Civil Code recognizes contracts for purchase-sale, compensated rendering of services, leases, carriage, and loan and credit, to name a few.⁹ Although freedom of contract is proclaimed in Article 1 of the Civil Code, as a practical matter, notaries must certify many contracts before they become enforceable.¹⁰ Strict conformance to statutory norms is an unaccustomed practice in Anglo-American law. Litigation also revealed some uncustomed practices. Courts outside Moscow deciding lawsuits for misappropriation of a joint venture's assets were heavily influenced in favor of Russian constituents, who had seized assets they were supposed to own jointly with foreign partners.¹¹ Even when a court did rule in favor of a foreign partner, the court bailiff was unable to enforce the ruling.¹²

This article discusses how two Americans attempted to thread their way through the Russian legal maze and preserve their investments. One American succeeded against all odds in the warehousing and plywood businesses; the other failed. He thought he had a binding contract to publish medical journals but was ousted from the business just as it began to make profits. To better understand their stories, general problems of investing in Russia will be examined first, followed by descriptions of particular legal problems they encountered.

II. Problems When Investing in Russia

A. NONLEGAL PROBLEMS

Perhaps the most notable nonlegal problem is that many former soviet managers continue to run newly privatized businesses and refuse to adopt Western management methods. They have no understanding that when equipment is idle, money is lost in wasted capital. For them, time is not money. Furthermore, they must tell workers whose lives have always centered around the factory precisely what to do.¹³ Initiative was destroyed during the Soviet period when factories were responsible for nearly every family need: housing, food, sports facilities, and vacations at cabins in nearby woods or at Black Sea resorts.¹⁴ This, then, is the labor pool the two American investors encountered.

7. *Id.* at 167.

8. See THANE GUSTAFSON, CAPITALISM, RUSSIAN-STYLE 155 (1999).

9. BUTLER, *supra* note 6, at 354-56.

10. *Id.* at 190, 352.

11. GUSTAFSON, *supra* note 8, at 159-61.

12. *Id.* at 165-66.

13. Interview with Vincent Tarride, Deputy Chairman of the Board, Commercial Bank Evrofinance, in Moscow (Apr. 15, 1999).

14. ROSE BRADY, CAPITALISM: RUSSIA'S STRUGGLE TO FREE ITS ECONOMY 20-21 (1999).

Another problem is that Russia has no culture respecting ownership rights in businesses. Joint ventures were the only way for Americans to enter the Russian market during the Gorbachev era.¹⁵ Later, when 100 percent ownership was permitted, Americans mistakenly continued to form joint ventures because of their perception that they needed a Russian partner who knew the market, controlled the use of buildings (since they were not available for purchase), and had access to raw materials. Too late, American investors realized that it is best to do business in Russia on a small scale to accumulate experience before committing significant capital for an interest in a factory. Many investors learned after they bought shares that they were shut out of shareholder meetings. Sometimes Russian partners simply barred their American partners from the business premises. In these and other ways Russians appropriated assets, and the saying among disappointed Americans was that “the Russians just want to make our money their money.” Some observers believe there have been no successful Russian-American joint ventures.

The mentality of Russians toward capitalism is shaped by the former crime of *spekulatia*. During the Soviet period, *spekulatia* was the illegal acquisition of state property (almost all property was state property) and its resale at a higher price. Many Russians still consider it unethical to profiteer by “buying cheap and selling dear.” But now that it is possible to ignore tradition and venture into capitalism, Russians discover that capital is not available. During the 1990s, banks did not perform the usual function of providing capital loans for starting or expanding a business. Before the crash of the banking system on August 17, 1998, Russian banks invested much of their depositors’ money in government bonds called GKO (gookohs in common parlance). Because GKO were backed by the government, they were thought safe and GKO interest rates were higher than the rates that banks could get from businesses on borrowed money. Consequently, little money was made available to businesses. The annual loan rate was always high by Western standards, but after the crash the rate quoted to private businesses was often 80 percent, and few businesses wanted loans at such rates.¹⁶ On August 17, the government defaulted on GKO and the banks in turn defaulted on money they owed to ordinary Russian depositors. Only the old, state-owned SperBank (now partially privatized) assured depositors their money was safe, and even SperBank froze depositors’ accounts for several months. By 2000, banks were still so unsound and so distrusted that most Muscovites kept the bulk of their savings in dollars hidden in their apartments. This explains why, on floor after floor of the large apartment houses in Moscow, apartment owners and lessees went together to finance steel doors to protect their corridors against burglars.¹⁷

A final nonlegal problem for American investors in the 1990s was that land could not be purchased. The Communists, who remained the dominant force in the Duma during the late 1990s, blocked passage of a proposed law on the ownership of land.¹⁸ Investors had to do business on land owned by local governments, state-owned enterprises, or recently privatized state enterprises. Some sources of land and capital available to Russians are not available to Americans. For example, city or state officials in control of public resources (buildings and tax revenues) would make them available to friends and relatives. In addition

15. BUTLER, *supra* note 6, at 439–40.

16. Interview with Vincent Tarride, *supra* note 13.

17. In Moscow, families occupying apartments, called *quartiere*, were given the option to buy them from the city.

18. GUSTAFSON, *supra* note 8, at 155.

to making public buildings and financing available, they would help them obtain business permits, smooth the way for products through customs, and make permits and space for competitors difficult to obtain. For example, the unlikely owners of a successful cosmetics business in a northern city averaged only twenty-five years of age. Their fathers were officials in the city government, and the children were fronts for their family business.¹⁹

B. LEGAL PROBLEMS

Problems with legal advice existed alongside nonlegal problems. Early in the 1990s, U.S. firms established Moscow branches to advise clients on Russian law. Unfortunately, the laws were not clear and Russians themselves tended to ignore them. The law was clarified when the Civil Code became effective in January 1995, but the Code created technical obstacles to the formation of contracts that were foreign to common law. Even with the technical obstacles, things improved because at last a legal structure for business agreements could not be concluded with more certainty. But Russian lawyers understood better than American lawyers that much would still have to be accomplished outside the legal structure, and that friends in the ministries would be needed. American lawyers found it more difficult to operate in this climate than Russian lawyers. For example, corruption (*korrupcia*), in the form of bribes for favors from public officials, is commonly accepted by Russians as a cost of doing business. Americans, however, have to contend with the Foreign Corrupt Practices Act²⁰ and are inept at playing the game of bribing bureaucrats. Among the most common form of corruption is the complicity of officials in tax avoidance. Russian companies have kept white and black books of account.²¹ The white books show a modest profit, most of which goes to the government for taxes. The black books show the much larger actual profit that is shielded from taxation. Private schools in Moscow sprang up to teach young Russians how to keep two sets of books.²² When a company's black book is uncovered by tax authorities the owners find it cheaper to attempt to bribe a tax official than to pay the overdue taxes and fines. And as long as cheating on taxes takes place, the mafia has cover, for it is impossible for *biznesmen* to enlist the government's help in combating *Krisha*²³ while they, themselves, have so much to hide from the government. Furthermore, as long as *biznesmen* perceive the need to bribe officials in order to do business, black books will be needed to conceal the cash with which to make bribes. Bribes can only be made safely with cash that is not traceable to a bank account. It is a vicious circle.

C. THE COMMERCIAL COURTS

During the 1990s, the Russian Arbitrazh courts (the specialized courts created in the Constitution for business disputes) were getting accustomed to the new legal structure.²⁴

19. Interview with Professor Evgeny Martinenko, RPFU, in Moscow (Mar. 8, 1999).

20. Foreign Corrupt Practices Act of 1977, 15 U.S.C. §§ 78dd-1,-2, 78ff (1994).

21. GUSTAFSON, *supra* note 8, at 194-206.

22. Interviews with students at the Russian Peoples Friendship University in Moscow (Mar. 1999). The interviewees asked that their names not be disclosed. The faculties of law and business at publicly-supported universities such as Russian Peoples Friendship University offered no such courses.

23. *Krisha* means roof in Russian and stands for the practice of paying money to so-called mafia thugs who promise to keep a protective roof over the business.

24. See GUSTAFSON, *supra* note 8, at 161-67.

Judges trained under the Soviet system lacked understanding of investment problems and, indeed, sometimes there were no laws to cover the cases before them. Since Russia is a civil law country, and not a common law country, judges do not fashion remedies unless they are supported by statute. Furthermore, some judges were prejudiced against foreigners. These weaknesses in the judicial system caused Americans to put arbitration clauses in their joint venture agreements and contracts. Arbitration, not to be confused with litigation in Arbitrazh courts, is a private settlement regime financed by the parties and often is conducted under rules of the Swedish Chamber of Commerce. Arbitration did not solve the Americans' problems, however. After an American received an award in an offshore arbitration forum, Russian courts could not be relied upon to confirm it. At the end of the 1990s, an arbitration award in Stockholm for Subway, an American investor, was finally confirmed by a Russian court. But Subway was foiled by the rudimentary enforcement system, because it could not get the *pristovs* (bailiffs) to carry out the court's judgment. *Pristovs* rarely could find any significant assets in the hands of losing Russian parties and their bank accounts seldom contained any money by the time judgment was confirmed. In the case of Subway, the *pristovs* simply backed down when challenged by the wrongdoers.

III. Jeffrey Sweetbaum: An American Entrepreneur

Jeffrey Sweetbaum is an American who found his way through the Russian legal maze and could become a role model for American investors. He was a costume jewelry maker in New York City in December 1989 when a motorcade for visiting Soviet Premier, Mikhail Gorbachev, stopped all traffic.²⁵ Impressed, he left for Moscow two weeks later in the vanguard of young Americans looking for business opportunities as Communism crumbled. An acquaintance in New York had shown him some hammer & sickle pins manufactured by IGRA, a Russian cooperative. He located IGRA in the yellow pages (*spravichnaya*) and ordered 36,000 pins at ten cents apiece. Back in New York, he sold 18,000 at seventy-five cents apiece, making a profit of about \$8,000.

He returned to Moscow early in 1990 and rented an apartment that became his home for the next five years. On Gorky Street (now Tver Street), he bought himself a green rucksack from a sporting goods trading company, Mosobtsport Prepriatia, and discovered he could also buy them in quantity for export. The associations that developed during these rucksack dealings would become very significant later in Sweetbaum's developing career in Russian business. He had to obtain the rucksacks by barter because international banks recognized no exchange rate for dollars and rubles. Fortunately for Sweetbaum, Russia had no export or import taxes at that time. His only problem (besides finding a buyer for the rucksacks) was that no U.S. Customs codes existed for items imported from Russia. After the problems were solved, however, he went on to export hockey sticks, custom-painted matryoska dolls, and, finally, plywood. Along the way he learned to be very careful when working within the Russian banking system and to avoid the concentration of financial assets in Russia. He also learned that Russians had little knowledge of Western accounting practices, and the information contained in the Russian, tax-oriented accounting system was of limited use. In all his ventures, great care has been taken to maintain accurate accounting records according to international standards.

25. Interview with Jeremy Sweetbaum, in Moscow (Apr. 8, 1999); Interview with Barry Thomas, Jeffrey Sweetbaum's Financial Director, in Highland Heights, Kentucky (Feb. 2, 1999).

Sweetbaum's most successful business began in 1992 when he received a request for help from people with whom he had become acquainted during his rucksack dealings. They controlled a large Soviet trading company and warehouse complex in south Moscow. The company, Optgalant, had excess space and wanted to attract a Western rental client. With remarkable foresight, Sweetbaum had already persuaded Optgalant to privatize its business in 1991 before the massive privatization program of Anatoly Chubais was underway.²⁶ He realized that private companies, but not state enterprises, could grant leases on their real estate. Sweetbaum advertised the Optgalant space in the *Moscow Guardian* and Colgate Palmolive Peet Co. responded. But instead of turning this potential renter over to Optgalant, he leased the warehouse himself, and then subleased space to Colgate and Johnson & Johnson, Inc. He decided to become a middleman because he believed Optgalant alone "would screw it up."²⁷ This was the beginning of what would become a huge and very successful warehouse and logistics service business, ITEMS. With tongue in cheek, Sweetbaum would say that it all began very inadvertently.

At about this time a Russian named Vladimir Saltykov approached Sweetbaum for a job. Sweetbaum hired him at \$200 per month and said, "go find something to do."²⁸ Saltykov knew about a plywood mill in the city of Kostroma about 200 miles northeast of Moscow with product to export but no export license. Licenses were held only by foreign trading organizations (FTD), or *Vneshekonomicheski organizatsi*, held over from the Soviet system. Working through one of these FTDs, Sweetbaum began buying and exporting the plywood to an English buyer. When the Fanplit Mill at Kostroma was privatized in 1993, Sweetbaum decided to borrow some money and invest in it.²⁹ Shares in the factory could be bought with vouchers available from brokers who had bought them from Russians. Although the value of these vouchers fluctuated, Sweetbaum was able to buy 6,000 at \$8 apiece from one broker, Troika Dialog. He then traveled to Kostroma where the Kostroma Privatization Committee was going to auction some Fanplit stock to bidders.

Taking advantage of this system of privatization auctions open to foreigners, Sweetbaum submitted his 6,000 vouchers to the Kostromo Privatization Committee. Forty percent of the shares of Fanplit were being auctioned. Since others submitted only 3,000 vouchers, Sweetbaum's 6,000 vouchers would purchase 25 percent of Fanplit, or at least he thought they would. The director of the privatization committee informed him that his vouchers had not been properly notarized and could not be accepted. The resolution of this and other issues required substantial time, a lot of persistence, and a willingness to achieve detailed understanding of the privatization law that was, at the time, "a work in process."³⁰ Eventually, Sweetbaum's vouchers were determined to be legal, and he was able to move, with strong community support, to consolidate his position. Just owning shares in Russia did not mean Sweetbaum could immediately assert his shareholder rights, however. He recognized that as long as he had only a minority interest he would be at the mercy of

26. See GUSTAFSON, *supra* note 8.

27. Interview with Jeremy Sweetbaum, *supra* note 25; Interview with Barry Thomas, *supra* note 25.

28. Interview with Jeremy Sweetbaum, *supra* note 25.

29. In several of his ventures in Russia, Sweetbaum has benefited from the business and financial support of Len Blavatnik. Blavatnik was born in Russia, educated in America, and naturalized as an American citizen. He has had success in Russia by investing in coal, copper, and nickel, and gained control of OAO Tyumen Oil, one of Russia's largest oil companies. See Whalen, *supra* note 1.

30. Interview with Jeremy Sweetbaum, *supra* note 25; see Interview with Barry Thomas, *supra* note 25.

former Soviet managers who would not recognize his rights as a shareholder. Therefore, he decided to acquire full control of Fanplit and other businesses in which he invested. Anything less than control left Americans vulnerable to the ultimate loss of their investments.

Sweetbaum gained control of Fanplit by buying additional shares and went on to set up PLYCO, a Delaware company that owned Fanplit, and held interests in four other logging concerns. His success was partly the result of a \$5 million investment by the U.S. Russia Investment Fund (formerly known as the Fund for Large Enterprises in Russia), which took a 50 percent interest in PLYCO.³¹ Sweetbaum's methods of acquisition are further illustrated by his campaign to acquire control of Lespromservice, a forestry service company also located in Kostroma. According to an account in *The Moscow Times*,³² he tried to get a seat on the Lespromservice board by voting his 23 percent stake in April 1994, but the long-time Director, Anatoly Osipov, had collected 9,000 proxy votes from workers who owned 51 percent of the 27,000 shares outstanding. With these and his own 15 percent, Osipov was determined to block Sweetbaum's intrusion into management. At the meeting, Sweetbaum, remembering his experience with Fanplit, objected that the proxy votes did not bear notary stamps as the law required. He also pointed out that the list of candidates for the seven Board seats contained the names of three company employees and that under Russian law no more than one-third of the Board members can be employees. Sweetbaum argued in fluent Russian that the entire meeting could be invalidated for these reasons, but the Board was elected anyway. In the end, however, Sweetbaum won because some of the employees, nervous about the competency of management, began to sell him their shares in the days following the meeting. He stationed himself at the plant gate and warned them that Soviet-style directors would run the business into the ground if they did not sell their shares to him.

Perhaps even more dramatic was his hostile takeover of the trading and warehouse complex, Optgalant, from whom he had leased warehouse space for four years.³³ The immediate impetus for the takeover was that Optgalant raised the rent for ITEMS by 50 percent. Other restrictions had also been imposed that restricted the ability of ITEMS to properly serve its Western warehouse clients. In typical fashion, Sweetbaum put a van outside the warehouse complex and staffed it with representatives who offered to buy shares from employees. At the next shareholders meeting, 97 percent of the voting shares were cast for Sergei Isotov, Sweetbaum's candidate for general director. The takeover was complete.

Sweetbaum scrupulously followed Russian law in all he did. Much credit goes to his relationship with Vladimir Michaelovich Zaitsev, a former law professor from Russian Peoples Friendship University in Moscow, who guided Sweetbaum through the legal system and used an innovative technique to minimize exposure to legal problems. For example, Zaitsev advised Sweetbaum in structuring the management of the plywood business to set up "a management company" in which the top management of the plywood operation would be housed, along with Sweetbaum.³⁴ Once the necessary approval from the Anti-

31. In Summer 1999, Sweetbaum and the U.S. Russia Investment Fund sold PLYCO to a Russian investment group.

32. Steve Liesman, *Loggerheads*, MOSCOW TIMES, Apr. 16, 1994.

33. See Natasha Milevnic, *U.S. Trading Firm Acquires Optgalant*, MOSCOW TIMES, Aug. 17, 1996.

34. See *Zakon Aktsionarniye Obshestva of 1995*, effective Jan. 1, 1996; Interview with Vladimir Zaitsev, in Moscow (Apr. 6, 1999).

Monopoly Committee was obtained and the management company became a legal entity, several benefits were gained. There were economic benefits related to reduced salary and tax burdens, but the major advantage was that the separate legal entity made it easier to monitor and control mill management behavior.³⁵ Individual general directors have broad contractual powers under which they might make sweetheart contracts with their own private firms or exceed company limits for the purchase of raw materials. Also, general directors at the factory level were easy targets for criminal influence. Similarly, the tighter control achieved by centralized management somewhat insulated them. Finally, the Law on Joint Stock Companies provides that shareholders may sue the general director for losses incurred by the company as the result of his "guilty acts or failure to act."³⁶ Sweetbaum, as the owner, would not sue his own company, but there were other shareholders.

By the year 2000 Sweetbaum was a survivor, in the enviable position of owning one business, ITEMS, with excellent cash flow and being able to sell another, PLYCO, for a profit.

IV. David Uible's Experience

The investment climate in which Jeremy Sweetbaum thrived was not as favorable for David Uible, another young American entrepreneur.³⁷ Uible says he lost his investment because of a naiveté that was characteristic not only of many American entrepreneurs, but also of the U.S. government. The U.S. Department of Commerce encouraged Uible and other Americans to invest in Russia with little consideration of certain prerequisites for risk-taking: a stable government, a well-regulated banking system, a pool of capable managers, and laws favorable to investment.

In 1992 Uible visited Moscow on a U.S. Department of Commerce trade mission and was encouraged to sell used ultrasound equipment in Russia. Early in 1993, he was seeking a better way to advertise the equipment when his general manager, a Russian cardiologist by the name of Saveli Bashinski, made him aware of certain medical journals published by the Ministry of Health (MOH) in which he could advertise. Holdovers from the Soviet system, the journals were published on newsprint and without color but distributed to physicians throughout Russia. They were venerable—the journal of pediatrics dated back to 1902—but the MOH lacked the money and expertise to upgrade them to modern standards. At first, Dr. Bashinski accepted Uible's suggestion that they might want to purchase advertising space on back covers. Later, Uible approached the MOH with an offer to publish the journals, go to color, and get Western European advertising. Uible realized that publishing them would not be expensive if he used personal computers and MOH officials were enthusiastic to have him publish the journals. He asked for a ten-year license, lawyers drew up a contract, and it was signed by one of the two MOH officials believed to have authority to sign for the Ministry, O.E. Nifantiev, Head of the Research Department. According to a statement of facts by Uible's lawyer, "a collaboration agreement between the State Scientific Research Center of Preventative Medicine of the Ministry of Health of Russia and

35. Interview with Vladimir Zaitsev, *supra* note 34.

36. BUTLER, *supra* note 6, at 430.

37. Interviews with David Uible (Feb. 1999, Mar. 2000, and Dec. 2000). The author thanks Mr. Uible for making available the files on his Russian investment [hereinafter Uible Papers]. Copies are in the author's possession.

AOZT 'Cardiosphera' was completed on January 24, 1994. Under this agreement the Centre agreed to provide premises to Cardiosphera.³⁸ Cardiosphera was later renamed Media Sphera. Dr. Bashinski became general manager for Uible's new company, Media Sphera Closed Joint Stock Company,³⁹ and the editorial boards of the five journals agreed to stay on to work for Media Sphera.⁴⁰ Uible owned 93 percent of Media Sphera stock through his wholly-owned U.S. company, Rosegate Publishing, Inc. The five chief editors each owned 1 percent, and Dr. Bashinski owned 2 percent. Although Media Sphera did not own the journals, he felt secure with the long-term licensing agreement.

The licensing agreement did not require Rosegate to pay anything to MOH at the inception of the contract. Media Sphera started publishing immediately and invested about \$20,000 within a few months. The journals became very profitable and Uible stopped selling the less profitable ultrasound equipment. He reinvested much of the profit in upgrading the journals to a glossy, Western-style appearance with color; this, in turn, attracted advertising from distinguished Western companies.⁴¹ By May 1996, Media Sphera employed thirty editorial workers in rented space in Moscow, with computers as the main physical assets. The venture had been profitable since mid-1994, in spite of the required payments of one-third to one-half of the profits to the MOH official with whom the license had been signed. Uible believes the official kept the money and did not treat it as payment to the MOH. In other words, it was a bribe. Uible was approaching major Western publishing houses such as Reed Elsevier as potential purchasers of the business. Then, as he was about to leave his New Richmond, Ohio, home for a monthly trip to Moscow, an e-mail from O.E. Nifantiev of the MOH announced that his license was being terminated, the employees were being dismissed, and the editors had resigned.⁴² What was not explained was that the following week a new business called Media Sphera Publishing Group was registered in Russia with the same former chief editors of Media Sphera Closed Joint Stock Company as primary shareholders. In short, Mr. Uible experienced the business equivalent of a coup d'etat.

The e-mail recited that the five chief editors were "discontent with stability and reliability of Media Sphera as our partner," and that the "Charter Fund of Media Sphera is many times less than the minimum defined by legislation of Russian Federation."⁴³ The e-mail went on to declare that there was now "lack of a place for office" and that there had been a "cancellation of the Publishing Agreements of Journals."⁴⁴ The chief editors, in turn, wrote the MOH announcing that they "created a new juridicial body named 'Media Sphera Publishing Group' with a charter fund of 250,000,000 rubles" and that "we ask Russian

38. Letter from Leonid Zubarev to David Uible (June 25, 1999).

39. For a general discussion of closed stock companies, see BUTLER, *supra* note 6, at 425-31.

40. The journals and their chief editors were Dr. Belenkov, *Kardiologia*; Dr. Bezroukov, *Stomatology*; Dr. Veltishev, *Pediatrics and Perinatology*; Dr. Gusev, *Neurology and Psychology*; and Dr. Samsonov, *Dermatology and Venerology*. Uible Papers, *supra* note 37.

41. As an example, during the last half of 1994 the following companies were invoiced as follows: June 1, Bristol-Myers Squibb, \$2,455; August 2, Rhone-Poulenc Rorer, \$2,455; September 6, KRKA, \$1,355; September 15, Merk Sharp Dome, \$2,000; October 3, Knoll, \$3,155; and October 18, Aczneimittelwerk Dresden GmbH, \$2,300. The amounts were deposited in Rosegate's account at Bank Austria. Letter from Saveli E. Bashinski to Rosegate (Nov. 8, 1994) (copy on file with author in Uible Papers, *supra* note 37).

42. Interviews with David Uible, *supra* note 37.

43. E-mail from O.E. Nifantiev to David Uible (May 24, 1996) (on file with author in Uible Papers, *supra* note 37).

44. *Id.*

Ministry of Health to sign a new publishing agreement with this new juridical body.”⁴⁵ In a separate e-mail, Dr. Bashinski, Mr. Uible’s Russian manager, explained that on May 21 all employees had been thrown out of their offices “by order of Dr. Oganov,” the Director of the Institute of Preventive Medicine of the MOH where office space was leased, and all phone lines disconnected. He added that on May 22 and 23, most employees retired and Bashinski “personally decided to go out of business.”⁴⁶ Mr. Uible replied on May 28 to Nifantiev that he was shocked that Dr. Oganov had evicted Media Sphera employees without notice, disconnected the phone lines, and shut off all the electricity; Dr. Bashinsky “was physically threatened by two Mafia-type men who entered our office premises and suggested that he resign;” the employees were threatened into quitting and joining the new company; and, finally, Nifantiev cancelled the publishing contracts without any due cause and gave them to the new company.⁴⁷ In fact, on Monday, May 27, the new managers were already doing business as usual under the new ownership of the five editorial boards of ten to fifteen physicians each, with the name changed only slightly to Media Sphera Publishing Group.⁴⁸

Uible immediately began to challenge the takeover as illegal. He enlisted help from the U.S. Embassy, politicians, and lawyers, and even attempted in vain to get the MOH to agree to arbitration of the dispute. The laws governing conduct of Uible’s publishing business, however, were not like those in America. Russian businesses had no fear of a lawsuit for breach of contract. It will be recalled that Media Sphera rented space for the editorial staff. In fact, the space was simply made available in the Institute of Preventive Medicine of the MOH. Media Sphera paid monthly rent, not to the MOH or any other owner of the building, but to the director of the Institute as an individual. Media Sphera did not sign a lease with anyone. The renting of space was informally arranged with this individual and, as Mr. Uible says, the rent was going up month by month. In the booming Moscow business climate of the mid-1990s, space was at a premium and was sometimes available only when the person in control of a building found a way to squeeze more people in. There was no way to enforce informal arrangements to occupy space that was made available only by the grace of the rightful occupant.

Another unusual aspect of Mr. Uible’s business was the informal arrangement to pay employees. In the United States, members of editorial boards of scholarly journals serve without pay, although the prestige can enhance their careers. Since the Russian physicians on Mr. Uible’s board received wholly inadequate salaries from the MOH, however, Mr. Uible supplemented them from Media Sphera profits. He gave the chief editors of each board \$1,200 cash each month, to be divided among members as they saw fit. In addition, he paid the chief editor a 20 percent commission for each advertisement he brought to the journal. Unfortunately, these payments revealed the gross revenue of Media Sphera. The chief editors calculated that the journals were very profitable and, in fact, Uible repatriated \$20,000 to \$30,000 to the United States after many of his monthly visits.

Uible was courting disaster. He had intended from the beginning to build up the business so that it could be sold to a Western publisher, but there was never a legal entity to be sold.

45. E-mail from Chief Editors to O.E. Nifantiev (May 20, 1996) (on file with author in Uible Papers, *supra* note 37).

46. E-mail from Savali E. Bashinski to David Uible (May 24, 1996) (on file with author in Uible Papers, *supra* note 37).

47. E-mail from David Uible to O.E. Nifantiev (May 28, 1996) (on file with author in Uible Papers, *supra* note 37).

48. Interview with David Uible (Feb. 9, 1999).

An agreement such as Uible's was not often enforced because of court expense and the unpredictable reception in court for foreigners. Furthermore, Uible made the mistake of being an absentee owner. Bashinsky ran the business in Moscow, keeping the American owner advised by e-mail at his New Richmond, Ohio, home. Uible made monthly visits to Moscow and carried home cash, not realizing that Russians tend not to understand absentee ownership. The fact that Uible was not heavily involved in the business but reaped the lion's share of profits was surely abhorrent to his Russian associates.

In May 1996 the door was open for a takeover, Russian style, which was accomplished by locking out the owner. Mr. Uible reacted indignantly as would any American investor. After all, he had a licensing agreement signed by a MOH official with power to sign, and now that official was disavowing his own signature. The physician-editors and MOH officials had taken away his business and left him with a shell of a company with no publications to sell. For two years he conducted a vigorous campaign to recover the business or legal damages. Finally, he realized no one could help him and that most of the officials he had dealt with in the MOH and U.S. Embassy had moved on to other postings. His battle to regain control illustrates the differences between the American and Russian legal systems. He hired McKenna & Co., a U.K. law firm with offices in Moscow that immediately called the MOH's attention to violations of Russian law perpetrated in the takeover. Its letter to the MOH lists violations of law for which, ultimately, no practical remedy existed in Russia at that time. The letter reads as follows:

Mr. Vilken
Deputy Minister
Ministry of Health
of the Russian Federation
MOW/DO395/44214.1

28 January 1997

Dear Mr. Vilken,

Thank you very much for your letter No. 2510/207-97-26 of 13 January 1997.

We would like to draw your attention to the fact that although there is no business relations between the Ministry of Health of the Russian Federation and AOZT "Media Sphera" the Ministry of Health is, however, liable for the breach of its contractual obligations under the contracts for publishing journals "Stomatologiya," "Russian Bulletin of Perinatology and Paediatrics," "Journal of Neuropathology and Psychiatry in the name of S. S. Korsakov," "Bulletin of Dermatology and Venereal Diseases" and for its unlawful actions in relation to AOZT "Media Sphera" as a co-founder of the journal "Cardiology." The Ministry is, therefore, a defendant in relation to AOZT "Media Sphera" in accordance with Article 450 of the Civil Code, Article 7 of the Law of the Russian Federation "On Foreign Investments," the provisions of the Law of the Russian Federation "On Mass Media" and the provisions of the Law of the Russian Federation "On Competition and Limitation of Monopolistic Activity on Commodities' Markets."

The statement of the Ministry of Health of the Russian Federation that it was not in possession of any information relating to the conflict between the Ministry and AOZT "Media Sphera" does not correspond to the facts. On 28 May 1996 Mr. David Uible, the Chairman of the Board of AOZT "Media Sphera" wrote a letter to Mr. Nifantiev, Head, Research Department of the Ministry of Health of the Russian Federation in which he expressed his protest against the illegal actions of the Ministry of Health of the Russian Federation. Furthermore, there was

a meeting between Mr. Nikolai Drozdov, Deputy Minister for Foreign Economic Relations and Russian Ombudsman for Commercial Relations with the United States, and Jan Kalicki, Counselor to the U.S. Department of Commerce and U.S. Ombudsman for Commercial Cooperation with the Russian Federation, which took place in Moscow on 22 October, 1996 and at which, amongst other matters, the conflict between the Ministry of Health and AOZT "Media Sphera" was discussed. Finally, at the same time there was a meeting in Moscow between a representative of the Ministry of Health and Deputy Assistant Secretary of the U.S. Embassy Michael Copps where, amongst other matters, the conflict between the Ministry of Health and AOZT "Media Sphera" was considered.

The statement of the Ministry that the letter of 5 July 1996 was not received at the address of the Ministry also does not correspond to the facts. The letter of 5 July 1996 and its copy were received by Gulova, an officer of the Ministry on 5 July 1996 which is supported by the attached copy of the receipt.

* * *

Taking the above into consideration we ask you to consider the question of concluding arbitration agreements with AOZT "Media Sphera" once again.

We await your timely response.

Yours sincerely,
Leonid Zubarev
McKenna & Co. International

Mr. Zubarev tried to get MOH to sign an agreement to arbitrate in the International Commercial Arbitration Court of the Chamber of Commerce and Industry of the Russian Federation. He described that forum as having the same status as the London Court of International Arbitration or any other international arbitration forum.⁴⁹ He observed that there was no agreement to arbitrate in the original agreements, however, and that arbitration could therefore only be with the consent of the MOH.⁵⁰ He stated, "Presumably, the MOH does not want to litigate at all, so I do not see any reason why they should agree in writing to litigate in the International Commercial Arbitration Court."⁵¹ Uible could lodge a claim in the state Arbitrazh court that would require up-front payment of state duties to the court and "it is practically impossible to foresee as to how long it may take to sue in Arbitrazh Courts."⁵² The duties Uible would have had to pay to lodge a claim at that time were approximately \$3,320 if the amount in controversy were \$200,000. The cost of arbitration would have been even higher.⁵³

Difficulties finding a forum were not the only problem. Uible's case itself appeared weak, as explained in the following excerpts from letters of Zubarev to Uible:

It appears that no publication agreement was ever agreed for "Cardiology", although "Cardiology" was published by "Cardiosphera" and then, at the beginning of 1994, by "Media Sphera."

* * *

49. Letter from Leonid Zubarev to David H. Uible (Nov. 25, 1999).

50. Letter from Leonid Zubarev to David H. Uible (Nov. 22, 1999).

51. Letter from Leonid Zubarev to David H. Uible (Nov. 27, 1999).

52. *Id.*

53. Letter from Leonid Zubarev to David H. Uible (Nov. 25, 1999).

“Media Sphera” was supposed to abandon the premises which it occupied. There is no evidence of a lease agreement for this premises and we understand that payments for rent were made in hard currency in cash.

* * *

“Media Sphera” would need to prove that it suffered damage as a result of the Ministry’s termination of the publishing contracts. Proving loss would be complicated by the fact that “Media Sphera” had effectively ceased business when termination occurred. The termination letter was dated 24 May 1996, by which time “Media Sphera” had been evicted from its premises and it seems the majority of staff had left. Unless “Media Sphera” had an enforceable lease agreement for its occupation of the premises (and we have seen no evidence of this), “Media Sphera’s” eviction was not unlawful and “Media Sphera” has no claim in respect of this eviction.

* * *

The decision of the editorial board to change to another publishing company is not unlawful. No agreement was concluded between the editorial board and “Media Sphera” as the publisher and the Law “On Mass-Media” imposes no obligation on the editorial board to restrict its [sic] collaboration to one publishing house.

* * *

“Media Sphera” could apply to the Moscow Department of the State Anti-Monopoly Committee of the Russian Federation on the basis of the breach of the anti-monopoly legislation. Documentary evidence of the breach would need to be included in the application. If, however, the application is successful, the Anti-Monopoly Committee would only order the editorial board to change the name of their company. It would not award you monetary compensation.

* * *

The Law “On Mass-Media” requires every periodical publication to contain the names of its founders. Since “Media Sphera” is a joint founder of “Cardiology”, that fact should appear in the magazine itself. At present the Ministry is named as the sole founder. The founder [MOH] has the right to compel the editorial board to publish a message or material in its name free of charge and for a specified period of time. The maximum extent of the material which the founder can require to be published should be identified in the charter of the editorial board or in the agreement between the editorial board and the publisher. *As far as we are aware, neither the charter nor the agreement exists*, [emphasis added]. Nevertheless, “Media Sphera” could require the Ministry to include its name into “Cardiology” as a co-founder.⁵⁴

* * *

Can the Head of Research, Nifantiev, within the MOH, have authority to cancel publishing agreements?

* * *

Generally speaking the Minister of Health or his Deputy may sign contracts and terminate them. Other officials may act on the grounds of resolutions adopted by the Minister or on the grounds of a Power of Attorney issued by the Ministry. As to Nifantiev, I think it would be difficult to prove that the termination itself was invalid. The Civil Code of the Russian Federation provides that a transaction committed without authority is invalid unless consequently approved by the person in whose name the transaction has been entered into. Hence, even if Nifantiev was not entitled to terminate the publishing con-

54. Letter from Leonid Zubarev to David Uible (June 24, 1999).

tracts his actions are not automatically invalid. I think the Ministry will approve his actions and make the termination valid from the date of the letter.⁵⁵

The points sound similar to points that could be made under English or American commercial law. Indeed, Russia strives to enact commercial laws that reflect Western norms. Litigation was not an option for most entrepreneurs, however, in part because the courts required deposit of the amount in controversy before litigation could begin.

V. Sweetbaum and Uible Compared

What conclusions can be drawn from this history? It is clear that many problems of American entrepreneurs resulted from enthusiasm untempered by understanding of the Russian legal system. Too many Americans believed Russia's new capitalism was governed by familiar rules similar to those in the West. Indeed, some laws being adopted indicated that Russia would imitate the Western system, particularly the civil law system of Europe. Vouchers had been converted to shares of stock, a stock market had emerged, and the law protected shareholder rights. But shareholder rights were secured only in theory. In reality, Russian entrepreneurs and former managers resented foreign ownership of the newly privatized businesses. As illustrated in the cases of entrepreneurs Sweetbaum and Uible, Russian shareholders simply refused to recognize foreign shareholders' rights. Sweetbaum, with a combination of bravado and legal advice, was able to obtain control of his companies by achieving 100 percent ownership and carefully observing Russian law. In contrast, many Russians felt they could not succeed while they observed the law, and thus, they put law-abiding Americans at a competitive disadvantage. Finally, American law firms set up offices in Moscow staffed by American lawyers and young Russian attorneys. American entrepreneurs often relied on them, but possibly they would have fared better with the advice of seasoned Russian lawyers who knew the bureaucracy as well as the emerging black letter law. Few relied solely on Russian counsel, as did Sweetbaum.

Uible believed he could place trusted lieutenants in charge of his business and reap the rewards of his investment. He was an absentee owner much of the time, and was unseated by the equivalent of a palace revolution. Although he owned the overwhelming majority of the shares in his company, minority owners saw that the company was making good profits that were going to Uible. In contrast, Sweetbaum eventually gained complete control of his companies so that he could keep their profitability confidential.

VI. Conclusion

The enthusiasm of Americans for investment in Russia came to an abrupt end in August 1998 when the Russian banking system collapsed. There had already been much bad publicity in the American press, however, about American investments that Russians had simply appropriated for themselves. There is some hope that a post-Yeltsin government will reform the tax system and enforce property rights already enacted into law. The rush to the Russian frontier of capitalism that developed in the 1990s is over, however. A golden opportunity to develop a strong trading partnership with Russia was lost, and now, as before the collapse of the Soviet Union, the only significant trade with Russia is in return for its raw materials. Young people who admire the scope of Western business enterprise are the hope of Russia. Most of their elders are hopelessly mired in the past.

55. Letter from Leonid Zubarev to David Uible (June 25, 1999).