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Riches to Rubles: Problems Russia Must Address to Increase Direct Investment from U.S. Private Equity

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RICHES TO RUBLES: PROBLEMS RUSSIA MUST ADDRESS TO INCREASE DIRECT INVESTMENT FROM U.S. PRIVATE EQUITY

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"The strengthening of our statehood has sometimes intentionally been interpreted as authoritarianism."[1]

- Vladimir Putin

I. INTRODUCTION

Private equity investments in Russia are increasing.[2] However, due to inadequate protections for shareholders, limited partnerships structure their investments in intermediate offshore holding companies, typically avoiding direct investment into Russia.[3] Consequently, in an attempt to increase direct investment into Russian companies and in response to the global outcry to provide greater protection for shareholders, Russia has implemented numerous rounds of amendments to the Law on Joint Stock Companies (JSC Law).[4]

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1. Seth Mydans, *Putin Accuses Critics of Working for Foreign Powers*, N.Y. TIMES, May 27, 2004, at A10 (quoting former Russian President Vladimir Putin).

2. HOLLY A. NIELSEN, DEBEVOISE & PLIMPTON, PRIVATE EQUITY IN RUSSIA 1 (2003), http://www.altaassets.com/casefor/countries/2003/nz3808.php.

3. Christopher Rose, *Inside Russian Private Equity Funds*, 18 RUSS./EURASIA EXECUTIVE GUIDE 2 (2008).

4. *See* Olga Lazareva, Andrei Rachinsky & Sergey Stepanov, *A Survey of Corporate Governance in Russia* 34 (Centre for Econ. & Fin. Res. at New Econ. Sch., Working Paper No. 103, 2007).

Amendments to JSC Law have in some cases undermined shareholders rights, led to additional abuses, and have been largely ineffective due to a lack of enforceability of shareholder agreements in Russia.[5] Rampant corruption and a judiciary that is often biased in its interpretations against foreign investors also negatively affect direct investment into Russian companies.[6] Even where judgment is impartial the amendments to JSC Law are complex and multilayered, which does not bode well for a judiciary that has failed to keep pace with the changes in economic legislation.[7]

Russia must confront these problems before making additional amendments to JSC Law.[8] If the Russian Duma[9] implements further amendments, it could create more problems and perpetuate an already ineffective system.[10] Russia must be patient and allow the current amendments time to trickle down through the civil law system and take effect.[11] Prior to making additional amendments to JSC Law, Russia should work to resolve the problems within its judiciary by strengthening enforcement mechanisms and confronting the corruption that exists at all levels.[12] Until these problems are addressed, private equity will continue to invest through intermediate offshore holding companies, and direct investment into Russia will suffer.[13]

This comment explains why U.S. private equity uses intermediate offshore holding companies when investing into Russia. It then analyzes three problems

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5. Robert E. Langer, Marc E. Gold & Mark A. Stoleson, *Private Equity Investing Under Russia's Amended Law on Joint Stock Companies*, METRO. CORP. COUNS. (Akin, Gump, Strauss, Hauer, & Feld, L.L.P., New York, N.Y.), May 2002, at 6; *see also* Lazareva et al., *supra* note 4, 22-24 (one example of such an abuse is an increase in hostile takeovers by corporate Raiders in Russia).

6. *See* US & FOREIGN COM. SERV., US DEP'T OF COM., DOING BUSINESS IN RUSSIA: A COUNTRY COMMERCIAL GUIDE FOR US COMPANIES ch. 6, § Corruption (2005) [hereinafter USDC].

7. *See* Digest of Commercial Laws of the World: Russia: Digest, 2005 Digest § Rus., at 2-6 [hereinafter Russia: Digest]; *see also* DIRECTORATE FOR FIN., FISCAL & ENTER. AFFAIRS, OECD, THE INVESTMENT ENVIRONMENT IN THE RUSSIAN FEDERATION: LAWS, POLICIES, AND INSTITUTIONS 16 (2001) [hereinafter OECD].

8. *See* Langer et al., *supra* note 5, at 6; *see also* Rose *supra* note 3, at 2; Russia: Digest *supra* note 7, at 2-6; Lazareva et al., *supra* note 4, at 33-34.

9. *See* BUREAU OF EUR. & EURASIAN AFFAIRS, US DEP'T OF STATE, BACKGROUND NOTE: RUSSIA *passim* [hereinafter USDS] (The Duma is the legislative branch in Russia which makes up part of the central government comprised of the eighty-eight regional subunits. The Duma, similar to the US House and Senate, must vote to enact legislation.).

10. *See* USDC, *supra* note 6.

11. Derek A. Bloom et al., Coudert Brothers L.L.P., Corporate Takeovers, Russian Style: How to Defend Against Them (Mar. 28, 2003) (unpublished article, on file with Tulsa Journal of Comparative & International Law).

12. *Id.*

13. *See* Rose, *supra* note 3, at 2; *see also* William Judge & Irina Naoumova, *Corporate Governance in Russia: What Model will Follow?* 12 CORP. GOVERNANCE 302, 303 (2004).

that Russia must address prior to making additional amendments to JSC Law and how addressing these problems may increase direct investment from private equity into Russian companies. Section II of this comment will provide a brief summary of private equity. Section III will offer a general overview of the current state of private equity in the United States. This section will then briefly explain how the current subprime lending crisis has threatened the U.S. private equity market and why private equity has begun to look abroad to Russia. Section IV will provide a general overview of the state of private equity in Russia. Moreover, this section will explain the use of offshore intermediate holding companies by U.S. limited partnerships and the consequences to direct investment in Russia. Section V will provide an analysis of the three main problems that Russia must address before enacting additional amendments to JSC Law. Additionally this section will discuss what strategies Russia should implement to solve its problems. Section VI will conclude and briefly summarize the changes that Russia needs to put into effect in order to increase direct investment.

Finally, it is important to keep in perspective that while the problems this article addresses are of primary importance, they are only half of the solution needed to increase direct investment from private equity into Russia.[14] A limited partnership seeking to invest in Russia will often make decisions largely driven by tax.[15] This article will not concentrate on the tax implications that must be considered by private equity when contemplating a direct investment into Russia. The tax issues are complex and are beyond the scope of what could be covered in this article.

II. A BRIEF OVERVIEW OF PRIVATE EQUITY: THE PLAYERS, LIMITED PARTNERSHIP AND TRANSACTION

In order to understand private equity in a more thorough manner, this paper will begin with a brief explanation using a metaphor that even the least savvy businessperson is sure to understand—the lemonade stand. Imagine you own a lemonade stand. You sell regular lemonade. The stand is doing well. You charge 10¢ a cup. You have a positive cash flow and make $2 dollars a week. The market around your neighborhood is above average. You work a square, four-corner block in City X, suburbia USA. The two corners on the east side of your block border a busy street so they do not matter; you never make any money there. The west side is where the money is. On the northwest corner, there is a trailhead next to a parking lot. Your house is adjacent to this trailhead, so you are able to obtain ice easily from your refrigerator and can provide a cold

14. Langer et al., *supra* note 5, at 6.

15. *Id.*; *see also* Rose *supra* note 3, at 2.

cup for customers. Money here is ok. There are a steady number of soccer moms jogging in the morning, middle school bike traffic in the afternoon, and the businessperson in the early evening looking to shed those extra pounds.

On the northeast corner is an untapped market, Memorial Park, which boasts some of the city's best basketball and tennis courts. The only trouble is that they are around four hundred yards from your house on the opposite side of the park. While you can make it to Memorial Park, your lemonade is warm by the time you get there, and no one wants a warm glass of lemonade on a hot day. Thus, you rarely sell a cup and decide your time is better spent focusing on the trailhead, but you can dream.

After some time, you realize that you are now barely breaking even. You decide that the park is the only option to save your business. However, there is still the problem of keeping the ice from melting and of keeping your lemonade cold. You do some research and find out that there are some power outlets next to the basketball courts. After looking through the Sunday classifieds, you find an ad for a small portable refrigerator. You want to buy the fridge, but it costs $100 dollars. You have nowhere near this kind of money. You are ten so you do not have the credit to obtain a loan from the bank, yet you know with some additional financing your lemonade stand will really start to grow and turn some major profit.

You decide to seek financing through your older brother. Having run many lemonade stands in his day, he is intrigued by your idea of expanding into the park. He agrees to finance the deal but is concerned about your management of the stand. He has a business degree and contacts in the Memorial Park basketball leagues and believes that with his skills he can ensure that the expansion is a success. In return for his investment he would like stock in the company and a managerial role with the stand to ensure his investment is highly profitable. You agree, but want to structure the arrangement in an agreement that lays out the rights and responsibilities of each party. He agrees and together you enter into an agreement and the expansion moves forward.

Although this example is an oversimplified version of private equity, it is an example that is easily understandable and holds some of the basic concepts within private equity. Private equity is a wide-ranging term that refers to different types of investments.[16] What these different types of investments have in common are an exchange in which private companies receive medium to long-term financing while investors receive a stake of equity in a company.[17] A private equity fund provides the financing and, in exchange for their capital,

16. DANIEL LEE & MATT SWARTZ, THE CORPORATE, SECURITIES, AND M&A LAWYER'S JOB 19 (Int'l Legal Publishers ed., 2007).

17. KEITH ARUNDALE, BRITISH PRIVATE EQUITY AND VENTURE CAPITAL ASS'N, A GUIDE TO PRIVATE EQUITY 6 (2004).

receives shares of the company's stock.[18] The shares of stock held by the private equity fund become partially owned by the investors who supply the capital for the fund to operate.[19] As a result, the investor shareholders' returns are dependent on the success of the company.[20] This sounds as though it is no different from a mutual fund, in which there is the purchase, holding, and sale of stock in a company; therefore, it is important to have a general understanding of some areas involving private equity in order to distinguish it from other types of investing.[21] First, it is important to understand the players involved in a private equity transaction.[22] Second, it is necessary to be familiar with the limited partnership structure to understand how the players interact.[23] Finally, a brief discussion of the typical private equity transaction will help to distinguish private equity from other types of investing.[24]

A. The Players

In a typical private equity transaction, there are three main players and a number of minor ones.[25] The three main players are the intermediaries, the investors, and the investee company.[26] The first player is the intermediary.[27] An intermediary is comprised of institutional investors (investors) and professional private equity managers (managers),[28] who are part of a private equity firm.[29] Henceforth, because the managers are typically part of the private equity firm, together they will cumulatively be referred to as the "fund."[30]

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18. LEE ET AL., *supra* note 16, at 19; *see also* Daniel E. Larkin, Mara L. Babin & Christopher A. Rose, *Structuring European Real Estate Private Equity Funds*, 3 BRIEFINGS IN REAL EST. FIN. 229, 229-235 (2003).

19. LEE ET AL., *supra* note 16, at 19.

20. *Id.*

21. *See id.*

22. GEORGE W. FENN ET AL., BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE ECONOMICS OF THE PRIVATE EQUITY MARKET 3-5 (1995).

23. *Id.* (For purposes of the page restriction on this paper, my primary focus will be the Limited Partnership. There are other organizational structures that are used for the intermediary structure however "[f]rom 1980 to 1994, the amount of capital under management by the organized private equity market increased from roughly $4.7 billion to about $100 billion, and limited partnerships went from managing less than 50 percent of private equity investments to managing more than 80 percent.").

24. *Id.*

25. *Id.* at 3.

26. *Id.* at 4 (noting that "Issuers" is the name used by the authors; however, for the purposes of this paper, I will refer to "Issuers" as either "prospective company" or "investee company".).

27. *Id.*

28. FENN ET AL., *supra* note 22, at 3.

29. *See id.*

30. *See id.*

An intermediary primarily takes the form of a limited partnership.[31] Under a limited partnership, there are limited partners and general partners.[32] The fund acts as the general partner while the investors act as the limited partner.[33] There are two primary types of private equity funds.[34] The first type is a subsidiary of a larger institution.[35] These subsidiaries are usually a division that specializes in private equity within the larger institution.[36] An example of this type of private equity fund would be an insurance company that has a private equity division.[37]

The second type of private equity fund operates as an independent entity that does not belong to a larger institution.[38] This type of private equity fund's sole purpose is private equity.[39] Both types of private equity funds have managers who are representatives of their funds and oversee investment within the investee companies.[40]

The general partner decides where and how to invest the limited partner's capital.[41] When a fund recognizes an investment opportunity, they obtain capital from the limited partner.[42] The general partner specializes in negotiating,

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31. *Id.* (noting that Limited Partnerships "manage an estimated 80 percent of private equity investments.").

32. LEE ET AL., *supra* note 16, at 67-68

> (Limited partners are shielded from personal liability for the partnership's obligations. General partners of limited partnerships are personally liable for the obligations of the general partnership. Each limited partnership must have at least one general partner. Limited partners who participate actively in the management of the business risk being deemed general partners by law.).

33. *See id.*; *see also* FENN ET AL., *supra* note 22, at 3.

34. JACK S. LEVIN, STRUCTURING VENTURE CAPITAL, PRIVATE EQUITY, AND ENTREPRENEURIAL TRANSACTIONS ¶102 (Martin D. Ginsburg et al. eds., 2006).

35. *Id.*

36. *Id.*

37. *See id.*

38. *Id.*

39. *Id.*

40. FENN ET AL., *supra* note 22, at 3.

41. LEVIN, *supra* note 34, at ¶103.

42. LUDOVIC PHALIPPOU & MAURIZIO ZOLLO, WHARTON FIN. INST., WHAT DRIVES PRIVATE EQUITY FUND PERFORMANCES? 4 (2005), *available at* http://fic.wharton.upenn.edu/fic/papers/05/0541.pdf; *see also* Jonathon Baird & Karen Fountain, *Private Equity Funds: US and UK Features*, PRACTICAL L., May 23, 2003, at 7, http://crossborder.practicallaw.com/5-102-3098

> (Limited partners are asked to commit a specific amount of capital when they subscribe for an interest in the fund. The capital contributions will be used to make fund investments and pay fund expenses. Limited partners will not generally be asked to contribute all . . . of their capital commitment at the time of their initial subscription . . . . Instead, a fund will call for, or drawdown,

organizing, and monitoring equity investments in investee companies.[43] Most private equity funds specialize in a specific industry or stage in company development.[44] Specialization allows private equity funds to become experts in recognizing prospective investee companies with potential for large growth.[45] It also enables a fund to take corrective measures to ensure that investee companies maximize their performance.[46]

The second type of player in a private equity transaction is the investor.[47] It is important to recognize there are different types of investors.[48] Depending on the type of investor, this can affect the strategy of a fund.[49] Some of the different types of investors in private equity include insurance companies, corporate pension funds, public pension funds, university endowments, foundations, bank holding companies, wealthy families and individuals, investment banks, non-financial companies, and other private institutions.[50] Although the investor is also the limited partner and part of the intermediary,[51] their primary purpose is to provide capital so the managers of the private equity fund can make investments.[52]

In exchange for their capital, investors anticipate a considerable return on their investment.[53] When the managers decide to invest, they will typically divide any profit from the investment between the fund and the investors.[54]

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capital contributions, on an as needed basis, generally as the fund makes investments, and commonly on ten days' notice.).

43. *See* PHALIPPOU ET AL., *supra* note 42, at 4; *see also* Baird, *supra* note 42, at 6.

44. DAVID E. VANCE, RAISING CAPITAL 143 (2005).

45. *Id.*

46. *Id.*

47. FENN ET AL., *supra* note 22, at 3; *see also* Grace Wong, *A Handy Private Equity Cheat Sheet,* CNN MONEY, Mar. 30, 2007, http://money.cnn.com/2007/03/30/markets/pe_cheat_sheet/index.htm.

48. *See* FENN ET AL., *supra* note 22, at 5.

49. *See id.*; *see also* Baird, *supra* note 42, at 16 (stating:

> ERISA is a significant concern for any fund, whether or not located in the US, that proposes to raise money from US pension plans or other US employee benefit plans. In order to protect participants in employee benefit plans, ERISA imposes strict fiduciary standards on the management of plan assets. In the case of a private equity fund with an ERISA plan as an equity investor, these may include all the fund's assets.).

50. FENN ET AL., *supra* note 22, at 4.

51. *Id.* (explaining that institutional investors act as the limited partner in the limited partnership structure).

52. Levin, *supra* note 34, at ¶102.

53. LEE ET AL., *supra* note 16, at 19.

54. LEVIN, *supra* note 34, at ¶102.

Managers of the fund receive one to three percent of the invested assets.[55] This is incentive for the managers to ensure the investee company is a success.[56] Prior to investment the limited partner and the general partner agree on the amount of profit each will receive in a partnership agreement, but typically, partners allocate profit in a 20/80 split.[57] Before paying the split, the fund will pay back investors their capital contribution.[58] Then 20% of the net profit goes to the fund.[59] This entitlement is also known as carried interest.[60] The remaining 80% of the net profit then goes to the investors.[61]

The third type of player in a private equity transaction is the investee company.[62] Private equity firms are usually interested in companies that have a high potential for growth and can offer the prospect of turnover within five years.[63] The characteristics of the prospective companies are typically low-risk companies with a positive cash flow,[64] and although these characteristics vary amongst investee companies, they all usually share the common trait of being a company that is in need of financing.[65]

This is where the private equity firm will often step into the equation and provide the financing needed.[66] Generally, there are four types of investee

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55. VANCE, *supra* note 44, at 143.

56. *Id.*; *see also* Wong, *supra* note 47.

57. *See* Baird, *supra* note 42, at 8.

58. *See id.*

59. LEVIN, *supra* note 34, at ¶102.

60. *The Taxation of Carried Interest: Hearing Before the Senate Comm. on Fin.*, 110th Cong. 6 (2007) [hereinafter CBO] (quoting statement of Peter R. Orszag, Director, Congressional Budget Office as saying,

> [a] general partner in a private equity . . . is typically compensated in two ways: through a fixed management fee and a share of profits . . . [t]he second component of the general partner's compensation is a share of the profits on the assets under management . . . [t]hat component, which is often 20 percent of such profits, is usually referred to as carried interest, or, simply, carry);

see also Baird, *supra* note 42, at 8-9 (explaining that carried interest is usually disproportionate to the amount of the funds capital contribution it is this profit entitlement that is the funds incentive to see that the investee company and the investment is a success).

61. LEVIN, *supra* note 34, at ¶ 102.

62. FENN ET AL., *supra* note 22, at 3.

63. ARUNDALE, *supra* note 17, at 6-9.

64. LEE ET AL., *supra* note 16, at 19; *see also* Mike Wright & Ken Robbie, *Venture Capital and Private Equity: A Review and Synthesis*, 25 J. OF BUS. FIN. & ACCT. 521, 538-39, (1998) (noting that in a study by Muzyka the criteria that private equity funds look for in a company were (i) good management team, (ii)reasonable financial return, and (iii) good market characteristics for the product or service).

65. *See* FENN ET AL., *supra* note 22, at 3.

66. *See* LEE ET AL., *supra* note 16, at 19-20.

companies that private equity provides financing for: the new venture, the middle market company, a company that is in financial distress, and a company for sale.[67]

The first type of investee is the new venture.[68] A new venture can mean one of two types of companies.[69] In the first type, a group of investors organizes a new company known as a start-up,[70] whereas the second type is a company that is already established but is in an early stage.[71] In both instances, the companies are young but have potential and need private equity to supply the capital for growth.[72] These types of situations are more typical for venture capitalists.[73]

The second type of investee is the middle market company.[74] The middle market company is usually a well-established company that is much larger than an early stage venture company.[75] It is stable and profitable,[76] and unlike other investee companies typically has the assets and credibility to borrow against and obtain financing through bank loans.[77] However, the middle market company is normally not able to obtain enough financing for its objectives.[78] The objectives that middle market firms generally seek are to change capital structure with new ownership, or to finance expansion.[79] Private equity provides the financing needed for either expansion or money to cash out the existing owners.[80]

The third type of investee is a company that is in financial distress.[81] The reasons companies perform poorly vary, but in this type of situation, the private equity firm takes on more risk than with a company that is stable and has a

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67. FENN ET AL., *supra* note 22, at 1; *see also* LEVIN, *supra* note 34, at ¶ 103.

68. FENN ET AL., *supra* note 22, at 17.

69. *Id.*

70. LEVIN, *supra* note 34, at ¶ 105.1.

71. FENN ET AL., *supra* note 22, at 3 (explaining that an early stage company is one that is in the research and development stage, shows potential for very high growth in the future, but needs capital to develop more rapidly).

72. *See id.*

73. *Id.*; *see also* LEE ET AL., *supra* note 16, at 19 (explaining that "[v]enture capital funds characteristically invest in higher risk, higher-potential-return investments, sometimes start-ups or companies with no cash flow.").

74. FENN ET AL., *supra* note 22, at 18-19.

75. *Id.* at 3 (explaining that a middle market company is "roughly defined as companies with annual sales of $25 million to $500 million . . .").

76. *Id.*

77. *Id.* at 19.

78. *Id.*

79. *Id.*

80. FENN ET AL., *supra* note 22, at 19.

81. LEVIN, *supra* note 34, at ¶ 105.3.

positive cash flow.[82] There are two types of companies in financial distress: private companies and public companies.[83] A private company usually is overleveraged[84] and needs financing to pay off loans.[85] A public company in financial distress is not able to access the debt market.[86] Accordingly, it is easier to negotiate a loan with a private equity firm in exchange for an interest in the company.[87]

The final type of investee is a company that is for sale.[88] In this type of situation, private equity provides financing to a buyer to purchase the company.[89] There are usually three potential types of buyers.[90] The first is a strategic buyer, who already owns a company similar to the prospective company and wants to acquire the prospective company in order to merge the two and produce an increase in value.[91] The second is a long-term buyer who wants to purchase the prospective company to move into the company's industry.[92] The third and final type of buyer is the financial buyer, who wants to acquire, improve, and sell the prospective company, with the final goal to make a profit in seven to ten years.[93]

B. The Limited Partnership

While the players involved in private equity are important, it is necessary to elaborate on the limited partnership structure in order to understand how the players interact. The limited partnership is the primary reason for the increase in capital[94] and success of the private equity market.[95] There are two primary types of partnerships, a limited partnership and a general partnership.[96] Under a

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82. *Id.*

83. FENN ET AL., *supra* note 22, at 19.

84. *See id.* at 20 (explaining that a company is overleveraged when "they show positive earnings before interest and taxes (EBIT)").

85. *Id.*

86. *Id.* (explaining the debt market is comprised of bank loans, private placement, or private bonds).

87. *Id.*

88. *See* LEVIN, *supra* note 34, at ¶ 105.3.

89. *Id.* at ¶ 105.4.

90. *Id.*

91. *Id.*

92. *Id.*

93. *See* LEVIN, *supra* note 34, at ¶ 105.4.

94. FENN ET AL., *supra* note 22, at 1 (explaining that "[f]rom 1980 to 1994, the amount of capital under management by the organized private equity market increased from roughly $4.7 billion to about $100 billion, and limited partnerships went from managing less than 50 percent of private equity investments to managing more than 80 percent.") (footnote omitted).

95. *Id.*

96. LEE ET AL., *supra* note 16, at 67.

general partnership, there are only general partners, each of which is personally liable for the debts and obligations of all the partners and the company.[97]

Under a limited partnership, there are one or more general partners and one or more limited partners.[98] General partners are liable for the debts and obligations of the company and the other partners.[99] However, limited partners are only liable to the company for their capital contribution and are not liable for the debts and obligations of other partners.[100] A partnership agreement between the limited and general partners controls the relationship and normally calls for the general partner to oversee management of the partnership.[101] Limited partners may not participate in management of the company.[102]

Although there are other structures that players in the private equity market can enter into, none has worked as efficiently in the United States as the limited partnership.[103] This is in part due to the pass through taxation that limited partnerships receive.[104] Under a pass through taxation structure, income of the limited partnership is untaxed and "flows through" directly to the investors.[105] Upon liquidation of an investment by the private equity firm, investors shoulder individual taxes on their share of the profit.[106] Although the tax benefits of a limited partnership are important, the structure is conducive to success as well.[107]

As discussed earlier, the limited partnership allows intermediaries to act as general partners on behalf of the limited partner investors.[108] This relationship maximizes efficiency by enabling the general partners to identify, structure, and manage companies.[109] The general partners also provide a small percentage of

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97. RICHARD HAMILTON, THE LAW OF CORPORATIONS 16 (5th ed. 1980).

98. *Id.*

99. *Id.*

100. *Id.*

101. Larkin et al., *supra* note 18, at 229-35.

102. HAMILTON, *supra* note 97, at 17.

103. FENN ET AL., *supra* note 22, at 1.

104. Marco V. Maotti, *Private Equity Funds: Current Terms and Trends Annex: Sample Term Sheet*, AM. SEC. L. WORKSHOP 2007, PLI Order No. 10866 at 217 (2007).

105. J. DENNIS HYNES & MARK J. LOEWENSTEIN, AGENCY, PARTNERSHIP, AND THE LLC.: IN A NUTSHELL 195 (3d ed. 2005).

106. Bridget Barker & Mark Baldwin, *Structuring Pan-European Private Equity Funds*, PRACTICAL L., Sept. 1, 2001.

107. LEVIN, *supra* note 34, ¶ 103.

108. FENN ET AL., *supra* note 22, at 1.

109. LEVIN, *supra* note 34, ¶103.

the capital.[110] The limited partners provide the remainder of the capital investment.[111]

The duration of the limited partnership is finite.[112] The usual lifetime of a limited partnership lasts ten years; however, an extension of up to four more years is available.[113] In the course of the first three to five years, the limited partnership invests capital in the prospective company.[114] At this stage, private equity distinguishes itself from other types of investing[115] because the general partners actively manage and influence the operations of the company.[116] They accomplish this through their financial, operating, and market expertise.[117] Some common modifications that general partners make are securing additional capital for the company, hiring top management, taking an active role on the board of the company, solving operational problems, evaluating company expenditures, and developing a long term strategy for the success of the company.[118] These services provided by the general partners are what distinguish private equity from other types of investing.[119]

C. The Transaction

A limited partnership provides financing in exchange for a stake in the investee company.[120] The stake the limited partnership receives from the investee company is more complex than simple debt or equity securities.[121] The securities provided by the investee company to the limited partnership are usually in the form of one of the following: common stock,[122] preferred stock,[123] dividends,[124] interest payments, or stock appreciation.[125] However, the favored

110. FENN ET AL., *supra* note 22, at 28.

111. *Id.*

112. LEVIN, *supra* note 34, at ¶103.

113. FENN ET AL., *supra* note 22, at 29.

114. *Id.*

115. *Id.* at 34.

116. *Id.* at 29.

117. *Id.*

118. *Id.* at 34.

119. FENN ET AL., *supra* note 22, at 34.

120. *See* VANCE, *supra* note 44, at 142.

121. Mitchell Berlin, *That Thing Venture Capitalists Do*, 21 FED. RESERVE BANK OF PHILADELPHIA BUS. REV. 15, 21 (1998).

122. *See generally id.* (explaining that common stock is the residual ownership interest in the investee company).

123. *See* HAMILTON, *supra* note 97, at 660 (explaining that the definition of preferred shares are "shares that have preferential rights to dividends or to amounts distributable on liquidation, or to both, ahead of common shareholders").

124. *See id.* at 649 (explaining that the definition for dividend is "a distribution to shareholders from or out of current or past earnings").

medium of security issued by investee companies to limited partnerships is convertible preferred stock.[126] This type of security provides the strongest incentive for both the limited partnership and the investee company to ensure that the investment is a success.[127] Although these types of securities help to align the interests of both the investee company and the limited partnership, there are still a great number of risks in the investment.[128] To help control these risks, limited partnerships enter into a shareholder agreement in which they negotiate for a series of rights.[129] A shareholder agreement governs the relationship between the investee company and the limited partnership.[130] A shareholder agreement contains key provisions that provide security for the

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125. VANCE, *supra* note 44, at 143.

126. *See generally* Berlin, *supra* note 121, at 21-22 (explaining the benefit of convertible preferred stock:

> Like a debt contract, *preferred* stock requires the firm to make fixed payments to the stock's holder. And the promised payments must be made before any common stockholder gets dividend payments, that is, the preferred stockholder has priority over common stockholders. Hence, the [fund] can make sure that the [investee company] is not paying himself a high salary disguised as dividends. It also means that if things turn out badly and the firm is liquidated, the [fund] gets back her investment in the firm before the [investee company] gets paid anything.
>
> Unlike preferred stockholders in many other settings, the [fund] usually has voting rights. In addition, the [fund] usually has a right of redemption, which means that she can cash out her shares at some predetermined price whenever she wants. Along with the fixed payments, both of these features give the [fund] multiple levers of control- as well as a way to make a quick exit if prospects look bad.
>
> With so many features that increase the [funds] influence, a well-designed contract should also have features leading her to use this influence in sensible ways. This is where the *convertibility* feature comes in. The right to convert her financial claims into shares of common stock focuses the [fund's] attention on the firm's market value. Since the firm's common stock will be valuable only if the firm does well, the [find's] vision is fixed on maximizing the value of the firm's stocks and ensuring that the firm succeeds. In particular, any incentive to cut her losses and run too quickly is reduced. (Footnotes omitted) (alteration to original)).

127. *Id.*

128. VANCE, *supra* note 44, at 148 (explaining that an investment has many risks including, technology risk, competitor third parties, lack of management skill or management incompetence, egos of owners of investee companies, finding the right company, market strategy).

129. *Id.* at 149; *see also The Trouble With Private Equity*, THE ECONOMIST, July 7, 2007, at 11 [hereinafter *Trouble*].

130. Simon Beddow, *Private Equity and Buyouts: Overview,* PRACTICAL L., Nov. 20, 2007, at 23, http://www.practicallaw.com/0-107-4033.

limited partnership until exit.[131] It can provide restrictions on what the investee company's management can do with the investee company without consent from the limited partnership.[132] To ensure greater security in their investment the limited partnership can negotiate restrictive covenants.[133] The agreement typically provides restrictions on the investee company's shareholders not to sell their shares in the company to third parties.[134] The agreement can provide a requirement that the shareholders of the limited partnership and the investee company follow the articles of association in any newly formed entity.[135] The agreement contains warranties and representations made by the investee company to the limited partnership.[136] If the limited partnership is the majority shareholder, it is typical that the limited partnerships insist that the other shareholders including the investee company enter into "drag along" agreements.[137] In the alternative, if the limited partnership is the minority shareholder, it can obtain "tag-along" rights.[138]

Finally, and possibly most important, is that a shareholder agreement allows shareholders to have a seat on the board of directors.[139] This allows the limited partnership to have a stronger position in the investee company, giving them access to inside information, the ability to actively participate and influence management, and to take part in the decision making process.[140] All of the rights that a limited partnership negotiates in a shareholder agreement are a

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131. *Id.*

132. *Id.* (explaining that this is what is known as veto rights).

133. *Id.* at 24 (explaining that a restrictive covenant is used "to prevent the [investee companies] management from engaging in competing businesses or soliciting customers, suppliers or staff for a period of time following completion of the investment and/or them ceasing to be an employee of, or shareholder in' Newco").

134. *Id.* at 23.

135. Beddow, *supra* note 130, at 23-24.

136. *Id.* (explaining that there are different types of warranties, some of the most common include: warranties that the management of the investee company will follow the business plan provided by the limited partnership; warranties that the investee company confirm that it provided accurate information to the limited partnership during the due diligence period; a warranty that there was an agreement of a duty by the investee company's management to not breach the terms of the shareholder agreement).

137. LEVIN, *supra* note 34, at ch. 9, 9-3 to 9-4 (A drag along right gives the limited partnership the right to find a buyer or several buyers for all or part of the investee company's stock and binds the investee company and other shareholders to cooperating in the success of the transactions.).

138. *Id.* (explaining that a tag-along right will give the limited partnership the right as a minority shareholder to sell their stock alongside the majority shareholders if they decide and have the right to sell their stock in the investee company).

139. VANCE, *supra* note 44, at 149.

140. *Id.*

means to an end and merely help to manage risk to meet the final objective of exiting an investment.[141]

An exit is the manner in which a limited partnership realizes its investment in an investee company.[142] An exit strategy is usually in place even before the limited partnership enters into a deal with an investee company.[143] The goal of the limited partnership's strategy is to maximize the value of the investee company and then to liquefy the investment for a profit.[144] There are different ways to exit an investment.[145] The most common exit strategies used in a private equity transaction are an initial public offering,[146] secondary buy-out,[147] a trade sale,[148] or a company buy-back.[149] With any of the exit strategies selected it is important that the limited partnership structure their rights from the very beginning of the transaction through a shareholder agreement.[150] This is to ensure that the limited partnership is able to maintain its rights throughout the investment and exit.[151] Often times upon exit from an investment, shareholders in the investee company disagree with the limited partnership on an issue or may not be completely satisfied with the outcome of the investment.[152] However, because of the negotiated rights in the shareholder agreement, the limited partnership is able to enforce its contractual rights.[153] Shareholder agreements

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141. *Id.* at 149.

142. *Id.* at 150-52.

143. AltAssets, Glossary of Private Equity and Venture Capital Terminology, http://www.altassets.com/hm_glossary.php [hereinafter ALTA] (last visited Feb. 21, 2008).

144. LEVIN, *supra* note 34, at ch. 9, 9-3.

145. ALTA, *supra* note 143.

146. *Id.* (noting that "An IPO is the official term for 'going public'. It occurs when a privately held company-owned, for example, by its founders plus perhaps its private equity investors –lists a proportion of its shares on a stock exchange").

147. *Id.* (noting that when one private equity fund sells its interest in a investee company to another private equity fund it is called a secondary buy-out).

148. LEVIN, *supra* note 34, at 9-3 (explaining that a trade sale is a sale of the investee company to a larger company in exchange for either stock in the larger company or cash or a combination of the two."); *see also* VANCE, *supra* note 44, at 153 (explaining that a trade sale will either occur to a publicly traded or privately held company. In both cases it is typical that the publicly or privately held company wants to take over the investee company to consolidate a specific industry and by taking over the investee company it can gain a stronger hold on the market in the specific industry).

149. ALTA, *supra* note 143; *see also* VANCE, *supra* note 44, at 153 (noting that a company buy-back is where the limited partnership sells its stock back to the investee company).

150. *See* LEVIN, *supra* note 34, at ch. 9, 9-3; *see also* Christopher Rose, *Don't Be the Second Little Pig*, INT'L FIN. L. REV., Jan. 2008, at 9, *available at* http://www.iflr.com/pdfs/private_equity_and_venture_capital/PEVCR01.pdf.

151. *See* LEVIN, *supra* note 34, at ch.9, 9-3 to 9-4.

152. *Id.*

153. *Id.*; *see also* Rose, *supra* note 150, at 9.

are largely unenforceable in Russia, and this is a primary reason why U.S. limited partnerships structure their investments through intermediate offshore holding companies.[154]

III. A BRIEF OVERVIEW OF THE UNITED STATES PRIVATE EQUITY MARKET

With each decade comes a new iconic figure that becomes the face of American Capitalism. During the 1980s, black Lincoln Town Cars chauffeured Wall Street investment bankers to and from their thrones on Wall Street.[155] The venture capitalist dominated the 1990s and threw the world into a "dot com" boom.[156] As the millennium passed it seemed as though the hedge fund manager would be the new rock star, but that changed with the rise of private equity.[157]

The ascent to eminence for private equity has occurred at a rapid pace.[158] The role of private equity on financial markets began as a trend but has since become a financial staple.[159] Statistics from Thompson Financial support the emergence of private equity in the U.S. markets and abroad.[160] In 2004, worldwide private equity increased by 40% over 2003, with $78.5 billion in private equity deals.[161] The growth continued in 2005 to $86 billion worldwide, with a 32% increase in U.S. private equity activity over 2004.[162] In 2006, growth continued with US private equity buyouts totaling $414.6 billion.[163] Investors spent $1.56 trillion on mergers and acquisitions in the U.S.,[164] of which 25% were private equity buyouts.[165] Furthermore, 2006 earned the mega-deal title, largely due to the size of the deals accounting for the vast sum of the growth, but the majority of the money came from private equity deals.[166] According to the Practising Law Institute, "[i]n 2004 private equity deals accounted for 31 of the 131 U.S. deals in the $1-10 billion dollar range, and for 18% of the value of such deals."[167] This amount increased in 2005 with private

154. Rose, *supra* note 3, at 2.

155. Nicholas Varchaver, *Private Equity in 2007*, FORTUNE, Jan. 22, 2007, at 21.

156. *Id.*

157. *Id.*

158. *See id.*

159. *See* David A. Katz, *Takeover Law and Practice 2007*, 1643 PLI/CORP. 855, 866-872 (2008).

160. *Id.*

161. *Id.*

162. *Id.*

163. *Id.*

164. Rik Kirkland, *Private Money*, FORTUNE, Mar. 5, 2007, at 50.

165. *Id.*

166. *Id.*

167. Katz, *supra* note 159, at 871.

equity transactions accounting for almost a third of the deals in the $1-10 billion range, roughly 27% of the value.[168] What is more staggering is that this trend has continued with private equity fundraising efforts in the U.S. last year accumulating a record $156 billion in new capital, and according to Blackstone,[169] the global fundraising effort has accumulated $400 billion that is ready for investment.[170] In terms of private equity, $400 billion leveraged represents[171] almost $2 trillion in potential buying power.[172]

However, there are two reasons why these numbers are misleading, and further, why private equity in the U.S. and more developed markets is likely to face serious obstacles.[173] First, as described above, private equity has raised record amounts of money.[174] This is partially because there are more private equity firms now than ever before.[175] Therefore, although there are record levels of fundraising and more private equity funds in the market, there is still the same amount of opportunity to create deals.[176] This means more competition, fewer deals to spread around, and consequently, lowered potential returns.[177] The markets are expanding and looking past the U.S. market and into countries where private equity is relatively new.[178]

Second, leverage is not as readily available as in the past.[179] Leverage, structuring deals using debt, is the primary reason why private equity is enjoying its high levels of success.[180] This is largely due to lenders providing cheap debt

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168. *Id.*

169. *See generally* Nelson D. Schwartz, *Wall Street's Man of the Moment*, FORTUNE, Mar. 5, 2007, at 74-78 (explaining that Blackstone is the top ranked private equity firm in terms of overall value and leadership).

170. Kirkland, *supra* note 164, at 50.

171. RVCA YEARBOOK 2004, RVCA PUBL'N (2005), http://www.rvca.ru/eng/show_info.php?=18.

172. Kirkland, *supra* note 164, at 50.

173. *Trouble*, *supra* note 129, at 11.

174. *Id.*

175. *Id.*

176. *Id.*

177. *Plenty of Alternatives: But Hedge Funds and Private Equity have their Limits*, THE ECONOMIST, Mar. 1, 2008, at 11-12.

178. *Trouble*, *supra* note 129, at 11; *see also Following the Era of Large Buyouts, Private Equity Funds find New Ways to Compete*, KNOWLEDGE @ WHARTON, May 6, 2008, http://knowledge.wharton.upenn.edu/article.cfm?articleid=1953 [hereinafter WHARTON].

179. WHARTON, *supra* note 178; *see* Kelly Candaele, *The Dangers of Private Equity Funds*, L.A. TIMES, Aug. 12, 2007, at M5; *see also* Anthony Hilton, *Stand By for a New Subprime Crisis*, THIS IS MONEY, June 3, 2008, *available at* http://www.thisismoney.co.uk/news/columnists/article.html?in_article_id=432235&in_page_id=19&in_author_id.

180. Varchaver, *supra* note 155, at 21.

to private equity funds because of more relaxed loan restrictions.[181] This is abruptly ending due to the sub-prime lending crisis in the United States and its effects on the debt market.[182] Where borrowing was once easy for private equity funds, rising long-term interest rates and restrictions on loans have decreased the amount of debt available to create leverage opportunities.[183] Creditors around the world have begun to restructure the way they lend as well, and the global private equity market has suffered.[184] While the rest of the world has felt the credit crunch, Russia seems to be a country that has remained largely unscathed by the effects of the subprime crisis.[185] Many growing Russian companies are now unable to obtain the financing needed to expand and, consequently, have turned to private equity for help.[186] However, historically Russia has not provided adequate protection to shareholders, which is of primary concern to private equity.[187] As a result, direct investment has been low; Russia has attempted to increase direct investment by amending JSC Law to provide for greater protections for investors.[188] These amendments have been unsuccessful as the majority of limited partnerships invest through offshore holding companies, instead of directly into Russian companies.[189]

IV. A BRIEF OVERVIEW OF THE RUSSIAN PRIVATE EQUITY MARKET

The subprime lending crisis continues to devastate mature markets throughout the world.[190] The financial chaos has struck mature markets much harder than emerging markets.[191] The growing Russian economy has yet to feel the impact and private equity investors speculate that the Russian market is a

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181. *Id.*

182. *Trouble*, *supra* note 129, at 11; *see also* Hilton, *supra* note 179.

183. Hilton, *supra* note 179; *see also* WHARTON, *supra* note 178.

184. *See generally Trouble*, *supra* note 129, at 11 (explaining that the sub-prime crisis has affected many deals throughout the world, in Australia because of the high cost associated with debt private equity firms pulled out of the country's biggest takeover deal; in Britain the sale of a large retailer was left dead after the withdraw of two large private equity funds); *see also* WHARTON, *supra* note 178.

185. Langer et al., *supra* note 5, at 6.

186. *Id.*

187. *See* Michael D.V. Coco, *Towards Enterprisation: Shareholder Rights and Economic Reform in Russia*, 39 VA. J. INT'L L. 169, 169-81 (1998).

188. *Id.* at 188.

189. *See* Rose, *supra* note 3, at 2.

190. Christopher Rose, *Private Equity and Venture Capital: Doing Deals in Russia: The Headlines are Encouraging but Read the Small Print*, FINANCIER WORLDWIDE, Jan. 2008.

191. Laura Kodres, *Supreme Fallout: Vulnerability Up in Some Emerging Markets*, IMF SURVEY MAG., Sept. 24, 2007; *see also* WHARTON, *supra* note 178; Rose, *supra* note 190.

safe haven.[192] On a macroeconomic level, foreign investment doubled in 2006 and doubled again to $50 billion in 2007.[193] Russia has the fastest growing IT industry in the world and is predicted to grow twenty percent annually.[194] The labor force is inexpensive and highly skilled.[195] Russia has massive oil and gas resources.[196] On a microeconomic level, 85 million Russians had sufficient disposable income in 2008 to afford consumer goods, making Russia the largest consumer market in Europe.[197] Additionally, Russia's development in the equity capital market among the central and eastern European countries makes it the region's financial center.[198] The economics of the post-Soviet market have been a catalyst for the private equity market during the last ten years in Russia.[199]

This surge in the area of private equity is largely due to a decade of economic reforms in Russia that has led to the privatization of many state owned companies.[200] These formerly state-run companies responded to the transformation by attempting to acquire capital to expand in an effort to keep pace with the new market-driven economy.[201] Private equity answered the call and provided the additional financing needed.[202] Not only did private equity provide the financing that facilitated the rapid growth, it also grew with the number of general partners in Russia having doubled and total assets rising from less than $500 million to over $5 billion over the course of the decade.[203] The majority of private equity investment is still in middle market companies, largely due to the expansion of the Russian economy and the privatization of formerly state-owned companies.[204]

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192. Rose, *supra* note 190.

193. *Id.*

194. *Id.*

195. APAX PARTNERS, UNLOCKING GLOBAL VALUE: FUTURE TRENDS IN PRIVATE EQUITY INVESTMENT WORLDWIDE 23 (2006).

196. *Id.*

197. Rose, *supra* note 190.

198. NIELSEN, *supra* note 2, at 1.

199. *Id.*

200. Robert Langer & Marc Gold, *Russian Issuers Return to the International Capital Markets* (Akin, Gump, Strauss, Hauer & Field L.L.P., New York, N.Y.), Aug. 26, 2002, *available at* http://www.altaassets.com/casefor/countries/2002/nz3096.php; *see also* NIELSEN, *supra* note 2, at 1 (noting that since 1994 more than 80 percent of the Russian economy is privately owned and the "government continues each year to sell off its remaining stakes in the major companies").

201. Langer et al., *supra* note 200.

202. *See id.*; *see also CIS Private Equity Report*, (Squire, Sanders & Dempsey L.L.P & C5, London, Eng.), Nov. 14, 2007 [hereinafter *CIS*].

203. Rose, *supra* note 3, at 2.

204. David Wack & Christopher Rose, *Private Equity 2006/07: Russian Federation: Country Q&A Russian Federation*, PRACTICAL L., Nov. 1, 2007, at 235.

When investing in Russia, U.S. limited partnerships in most instances do not directly invest in an investee company as they would in the United States.[205] Instead, most Russian private equity investments by U.S. funds are through a limited partnership in an offshore jurisdiction.[206] Although Russian law offers the legal structure for U.S. limited partnerships to invest directly in a Russian company, most U.S. investors find the provisions under Russian law to be unacceptable.[207] This is largely because under Russian law, shareholder agreements afford little protection should there ever be a dispute between the Russian investee company and the U.S. limited partnership.[208] As noted earlier, a shareholder agreement is especially important in a private equity transaction due to the finite period of the deal and the level of cooperation needed between the limited partnership and the investee company from the initial investment until exit.[209]

Although the limited partnership in an offshore jurisdiction still provides the same stability as in the United States,[210] this is irrelevant if the rights provided by the shareholder agreement between a limited partnership and Russian investee company are not legally enforceable.[211] Consequently, when structuring a deal with a Russian investee company, a limited partnership will typically use an offshore holding company as an intermediary.[212] The shareholders of the limited partnership and the shareholders of the Russian investee company create the offshore holding company as a separate entity.[213]

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205. Rose, *supra* note 190.

206. Rose, *supra* note 3, at 2; *see also* HILTON MCCANN, OFFSHORE FINANCE 15 (2006) (An offshore jurisdiction

> holds itself out as a financial services centre that enables financial services companies to conduct financial transactions—mainly with non-residents. The identity and the business of the clients will be regarded as confidential. The infrastructure of the jurisdiction is likely to include a benign fiscal regime that is underpinned by a tailored legislative, financial and regulatory environment.).

207. Rose, *supra* note 3, at 2; *see also* Posting of Dan Primack's Interview with Michael Bleyzer, CEO of private equity firm SigmaBleyzer, Private Equity and the Russia-Georgia Conflict, http://blogs.reuters.com/reuters-dealzone/2008/08/15/private equity-and-the-russia-georgia-conflict/.

208. Rose, *supra* note 190.

209. *See* VANCE, *supra* note 44, at 149; *see also* Gilles Chemla, Michael Habib & Alexander P. Ljungqvist, *An Analysis of Shareholder Agreements* 1-3 (RICAFE- Risk Cap. & the Fin. of European Innovative Firms LSE, Working Paper No. 006, 2004).

210. *See* MCCANN, *supra* note 206, at 76 (stating that a limited partnership in an offshore jurisdiction still includes: limited liability for investors, pass through taxation, and an efficient partnership structure between investors and the fund).

211. Rose, *supra* note 3, at 2.

212. Rose, *supra* note 190.

213. Rose, *supra* note 150, at 9.

Thus, instead of investing directly in a Russian company, the limited partnership shareholders will convince the Russian shareholders to bring their shares to the offshore jurisdiction to form the new holding company entity.[214] The primary offshore jurisdictions that U.S. limited partnerships use to invest in Russia are the Cayman Islands, Cyprus, Isle of Man, Guernsey, and Jersey.[215]

The limited partnership creates the offshore holding company in one of the above jurisdictions for two primary reasons.[216] First, by structuring the limited partnership in one of the above foreign jurisdictions, U.S. limited partnerships receive greater flexibility because of more established and favorable corporate laws.[217] Of particular importance is the right of the limited partnership to have their negotiated rights in the shareholder agreement enforced.[218]

Second, if the limited partnership were to invest directly in a Russian company, as a foreign entity that receives Russian sourced income, the limited partnership would be subject to Russian withholding tax.[219] However, by forming an intermediate holding company in an offshore jurisdiction,[220] the limited partnership can take advantage of the jurisdictions double taxation treaties in effect with Russia.[221] Estimates place some $6.5 trillion of assets offshore, which account for nearly sixty percent of the world's money.[222] Cyprus is usually the most favored jurisdiction, used for both its corporate laws and its favorable tax treaty for private equity funds investing in Russia.[223]

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214. *Id.*

215. *See* Wack et al., *supra* note 204, at 236; *see also* Rose, *supra* note 3, at 2 (explaining that "[t]hese jurisdictions are typically favoured above others because of their advantageous tax regimes and because they are familiar to most foreign investors"); Rose, *supra* note 150, at 9.

216. Rose, *supra* note 150, at 9.

217. Rose, *supra* note 3, at 2.

218. *Id.*

219. *Id.*

220. *See id.* (explaining that an intermediate holding company is used because as "Russian sourced income received by a foreign entity other than through a permanent establishment in Russia may be subject to withholding tax . . . , fund investments are often made through Cyprus, Luxembourg or Dutch holding companies which can take advantage of double-taxation treaties in effect with Russia.") (text omitted); *see also Russia and Offshore: Foreign Investors in Russia*, LOWTAX.NET, http://www.lowtax.net/lowtax/html/offon/russia/rus_offshore.html [hereinafter LOWTAX] (last visited Aug. 28, 2008).

221. *See* LOWTAX, *supra* note 220; *see also* Rose, *supra* note 3, at 2.

222. McCann, *supra* note 206, at xi.

223. Rose, *supra* note 3, at 2 (stating:

> Under the Cyprus-Russian tax treaty, Russian withholding tax on dividends is reduced to 5% if the Cyprus holding company invests at least USD $100,000 in its Russian subsidiary companies. Cyprus imposes a 10% income tax on the Cyprus companies income. However, the Cyprus company would be able to reduce this 10% tax by half through a credit for the 5% Russian tax. Cyprus

Cyprus was reportedly the largest foreign investor in Russia, investing nearly $2.3 billion.[224]

Apparently, this large amount of money circumventing the Russian Federation struck a chord with the government, and in an attempt to attract direct investment by providing greater protection for shareholders, the Russian government amended JSC Law in 1996, 1999, 2001, 2002, 2003, 2004 and 2006.[225] Although Russia purports that these rounds of amendments have increased shareholder protections, in reality they have not gone far enough and Russia must address three problems prior to enacting additional amendments to JSC Law.[226]

V. AN ANALYSIS OF THE THREE PROBLEMS THAT RUSSIA MUST ADDRESS BEFORE ENACTING ADDITIONAL AMENDMENTS TO JSC LAW

After the 1998 financial crisis Russian companies realized that foreign capital is therapeutic to ailing business, and in order to assure investment, certain standards of transparency, corporate governance, and accountability needed drastic changes.[227] Change arrived and amongst Russia's many reforms came the introduction of JSC Law.[228] Under JSC Law, some say corporate governance increased, while others would argue Russia has barely fulfilled its potential.[229] Regardless, the Russian economy has continued to grow and with its emergence on the global market, there has been a constant call for greater shareholder protections.[230]

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also imposes an additional 15% defence tax on the Cyprus company if the company does not distribute its income within two years. Because of the defence tax, the fund would want to distribute the income of the Cyprus company promptly each year.);

see also LOWTAX, *supra* note 220.

224. Langer et al., *supra* note 5, at 6.

225. *See* Lazareva et al., *supra* note 4, at 34.

226. *Id.*

227. *Id.*; *see also* WILLIAM H. COOPER, CONG. RESEARCH SERVS., 98-578: THE RUSSIAN FINANCIAL CRISIS: AN ANALYSIS OF TRENDS, CAUSES, AND IMPLICATIONS 1 (Digital Lib. of U.N. Tex. 1999).

228. *See* Lazareva et al., *supra* note 4, at 33.

229. Andrei Gusev & Sergei Federov, *Russia: Are Minority Shareholders Dying Out,* MANNHEIMER & SWARTLING, Mar. 22, 2008, http://www.mannheimerswartling.se/en/News/News-arcive/RUSSIA-ARE-MINORITY-SHAREHOLDERS-DYING-OUT/; *see also The Trouble with Russia's Economy: Smoke and Mirrors*, THE ECONOMIST, Mar. 1, 2008, at 27, 28 [hereinafter *Smoke*].

230. *See* Langer et al., *supra* note 5, at 6.

In response to the call for protection of shareholders from the global marketplace, Russian authorities amended JSC Law.[231] The amendments to JSC Law sought to provide greater protections to shareholders through stricter corporate governance and by strengthening the rights around shareholder agreements.[232] While the desire to provide protection for shareholders was undoubtedly important to Russian legislators, the amount of money lost due to offshore holding companies probably played an even greater role in the additional protections afforded to shareholders.[233] Consequently, the Russian Federation rushed to amend JSC Law in 1996, 1999, 2001, 2002, 2003, 2004, and 2006.[234] The enactment of many of these amendments created additional problems by undermining shareholder protections and made it clear that Russia's structural problems make additional amendments frivolous and wasteful.[235] Nevertheless, the Russian Duma have ignored these consequences and proposed an additional round of amendments to JSC Law that would strive to provide additional protections to shareholders in the hope of increasing direct investment into Russia.[236]

The Russian Duma should not enact the current amendments to JSC Law.[237] They must first address three problems prior to the enactment of any additional amendments to JSC Law.[238] First, the elimination of preferred stock voting rights has undermined private equity and increased hostile takeovers.[239]

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231. *See* Coco, *supra* note 187, at 183-85.

232. *Id.*

233. Wack et al., *supra* note 204, at 237 (explaining that since Russia has no limit on the amount invested through private equity offshore and private equity is increasing, Russia needs to implement changes or offshore investing will continue to grow unchecked).

234. Lazareva et al., *supra* note 4, at 33-34.

235. *See id.*; *see also* DELPHINE NOUGAYRÈDE & GEORGY KALASHNIKOV, DLA PIPER, RUSSIA CHAPTER OF THE IFLR CORPORATE GOVERNANCE GUIDE 2007, *available at* http://www.dlapiper.com/files/Publication/43f1be6f-6511-4a11-9563-2fe21a37fa50/Presentation/PublicationAttachment/d5f731a1-2fd0-49ba-a4b1-35a2d85d5256/RussiaChapterof%20IFLRCorporateMar2007.pdf.

236. Gusev et al., *supra* note 229.

237. *See* NOUGAYRÈDE ET AL., *supra* note 235; *see also* Ajay Sud, *The Legal Environment for Asset-Backed Securitization in Russia*, *in* EUR. BANK FOR RECONSTR. & DEV., LAW IN TRANSITION 2008 at 25-26 (explaining that there are already shortcomings within the legal framework and that because of subprime lending crisis and transparency issues within Russia a few negative court decisions, due to new legislation, could cause investors to lose confidence in the Russian Market); Gusev et al., *supra* note 229 (explaining that the amendments to the JSC made in January of 2006 had shortcomings, namely, "restricts the rights of shareholders, . . . contradicts the Constitution, . . . and contains a number of internal contradictions," and that its introduction will be problematic for the Russian courts because of the issues that it raises).

238. NOUGAYRÈDE ET AL., *supra* note 235, at 25-26.

239. Lazareva et al., *supra* note 4, at 33-34.

Second, shareholder agreements are unenforceable, and in the event of a breached agreement, shareholders have no recourse within the Russian Courts.[240] Third, rampant corruption still plagues Russia.[241] Finally, the Russian Judiciary is a weak mechanism of enforcement.[242] The Duma must confront these problems before enacting additional amendments to JSC Law, only then will private equity invest directly into Russian companies.[243]

A. Problem 1: Shareholder agreements are unenforceable and in the event of a breached agreement, shareholders have no recourse within the Russian Courts

Although there are many nuances that distinguish the Russian civil law system, it is evident from the many rounds of amendments to the JSC Law that the protection of shareholders' rights should be of primary concern.[244] However, courts often fail to protect shareholders' rights within shareholder agreements.[245] The lack of protection arises from provisions within shareholder agreements that are largely unenforceable within Russian Courts.[246] The Russian Civil Code provides that only provisions and warranties pertaining to the shares being acquired are enforceable.[247] Provisions contained in agreements that pertain to the shareholders and not the shares, such as veto rights, drag along rights, tag along rights, puts/calls, and other warranties, are likely unenforceable.[248] Thus, rather than directly invest in Russian companies, limited partnerships invest through offshore holding companies to ensure that

240. Alexei Knyazhev & Alexei Zakharko *The Use of Warranties in Russian M&A Transactions*, 18 RUSS./EURASIA EXECUTIVE GUIDE 7, 7-8 (2008).

241. Jim Argalas et al., *Russian Capital Markets*, GLOBAL INITIATIVES IN MGMT., KELLOGG GRADUATE SCH. OF MGMT., Apr. 17, 2001, at 18.

242. KENICHI OSUGI, OECD/ WORLD BANK CORP. GOVERNANCE ROUNDTABLE FOR RUSS., HOW SHOULD WE ENFORCE MINORITY SHAREHOLDERS' RIGHTS IN RUSSIA?: OVERHAULING THE SELF-ENFORCING MODEL OF CORPORATE LAW IN TRANSITION ECONOMIES 2 (2000); *see also* Andrei Yakolev, *Evolution of Corporate Governance in Russia: Government Policy vs. Real Incentives of Economic Agents*, 16 TAYLOR & FRANCIS J. 387, 396 (2004).

243. *See* Argalas et al., *supra* note 241, at 18-19.

244. *See* Lazareva et al., *supra* note 4, at 34 (explaining that if the Russian government is going to take the time to make amendments in 1996, 1999, 2001, 2002, 2003, 2004, and 2006, and are currently considering more amendments then it is a reasonable inference that shareholder protections should be of primary concern); *see also* David Wack, *Minority Shareholder Rights Under Russian Law*, 3 INT'L J. OF DISCLOSURE & GOVERNANCE 317, 317 (2006).

245. Rose, *supra* note 190; *see also* Wack, *supra* note 244, at 317.

246. Rose, *supra* note 190.

247. Knyazhev et al., *supra* note 240, at 7-8.

248. *Id.*

these provisions are enforceable.[249] Furthermore, in the event the agreement is breached, offshore jurisdictions allow for remedies that the Russian Civil Code does not provide.[250] Both problems are illustrated and analyzed throughout the example below.

Imagine that a U.S. limited partnership (USLP) has decided to invest in a Russian private company (RussianCo). Assume that the shareholders of RussianCo are the majority shareholders, and shareholders of USLP hold the minority in the transaction. In structuring the deal, RussianCo and USL.P enter into a shareholder agreement. The section of the agreement that deals with representation of the shareholders on the board of directors stipulates that RussianCo (holding 70 % of the company shares) have three representatives and that USLP (holding 30% of the company shares) have two representatives, and that regardless of the outcome of the vote at a shareholders meeting, each group of shareholders will be represented by the terms of the shareholder agreement.[251] The terms of the shareholder agreement therefore are contrary to the terms set forth in the company charter, which in Russia must conform with standards that correspond to those in JSC Law.[252]

Subsequently, at the annual shareholder meeting between RussianCo and USLP, the majority shareholders of RussianCo decide to elect five of their representatives to the board of directors and refuse to recognize the claim by USLP that according to the shareholder agreement, two of their representatives are supposed to be on the board of directors.[253] While it would seem the terms of the shareholder agreement should protect the right of USLP to have two seats on the board of directors, this may not be the case.[254] Under Article 48.4 of JSC Law, "the board of directors of a company is elected by a simple majority of shareholder votes."[255] Therefore, regardless of the terms that USLP and RussianCo have agreed upon in the shareholder agreement, because of Russia's

249. *See id.*; *see also* Josh Lerner & Antoinette Schoar, *Does Legal Enforcement Affect Financial Transactions?: The Contractual Channel in Private Equity*, 224 Q. J. OF ECON. 223, 224 (2005) (noting that "[p]arties cannot easily undo deficiencies of the law through private transactions if the legal system does not enforce certain types of contracts" since Russia does not enforce shareholder agreements limited partnerships would rather structure their shareholder agreement where it will be enforceable).

250. Knyazhev et al., *supra* note 240, at 7-8.

251. Peter A. Maximov, *Enforceability of Shareholder Agreements under Russian Law: Certain Aspects of the Existing Problem*, SQUIRE, SANDERS & DEMPSEY, June 30, 2006, http://www.lawfirm.ru/article/print.php?id=73.

252. *Id.* (inferring that under article 48.4 of JSC Law, "the board of directors is elected by a simple majority of shareholder votes" and the company's charter must conform to the laws of the JSC, therefore the company can only elect a board of directors by a simple majority vote).

253. *Id.*

254. *Id.*

255. *Id.*

civil system and its strict interpretation governing statutes, the candidates elected by a simple majority of shareholders will comprise the board of directors.[256]

In the U.S., shareholders can enter into a shareholder agreement that can change the voting threshold needed to elect an individual to the board of directors.[257] However, this is not possible in Russia because "[u]nder Russian law, provisions contained in any agreement that conflict with Russian legislation . . . are unenforceable."[258] Consequently, even though RussianCo breached the shareholder agreement with USLP, it elected the board of directors pursuant to the requirements of JSC Law by a simple majority and therefore elected the board.[259]

The question then arises whether USLP will be able to protect the rights agreed upon in the shareholder agreement through legal enforcement in Russia's judicial system.[260] In the U.S., "[m]ost shareholder agreements call for a remedy of specific performance in the event a given [shareholder] does not vote in accordance with the agreement."[261] Thus, the shareholders of USLP decide that they have two options: try to have the shareholder meeting annulled or sue for breach of contract.[262]

The first option for the shareholders of USLP is to have the decision made by RussianCo at the shareholder meeting annulled.[263] Under the Amended JSC Law, the basis for annulling decisions made at shareholder meetings can only occur if the decision contradicts JSC Law, another law of the Russian Federation, or the company charter.[264] In the case of the decision by RussianCo to disregard the provision of the shareholder agreement that allows USLP to

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256. *Id.*

257. *See* Langer et al., *supra* note 5, at 6.

258. Christopher Rose, *Comment: Doing Deals in Russia-5 Useful Tips,* BUSINESS NEW EUROPE, June 11, 2008, http://businessneweurope.eu/story1087; *see also* Maximov, *supra* note 251; *see also* PAUL E. RUBIN, PROMISES, PROMISES: CONTRACTS IN RUSSIA AND OTHER POST-COMMUNIST ECONOMIES 11-31 (1997).

259. Rose, *supra* note 258, at 6.

260. *Id.*; *see also* RUBIN *supra* note 258, at 11-31.

261. JEFFERY J. HAAS, CORPORATE FINANCE 13 (2004).

262. Rose, *supra* note 150, at 9.

263. *Id.*; *see also* Maximov *supra* note 251.

264. Maximov, *supra* note 251 (explaining that decisions for annulling shareholder meeting decisions are found in Article 49.7, where:

> [a] shareholder shall have the right to bring action in court to challenge a decision made at a general meeting of shareholders in violation of this Federal Law, other laws of the Russian Federation, the charter of the company, in the event he was not present at the general meeting of shareholders or voted against the adoption of such decision, and such decision violates his rights and lawful interests.)

(emphasis omitted).

have two seats on the board of directors, this clearly does not violate JSC Law or the company's charter.[265] Furthermore, it does not violate other laws of the Russian Federation.[266] Therefore, it is highly unlikely that USLP would have success in attempting to have the decision at the shareholder meeting annulled.[267]

The second option for the USLP shareholders is to sue for breach of contract.[268] The best-case scenario in a suit for breach of contract for the USLP shareholders in the context of a private equity transaction would be specific performance of the shareholder agreement.[269] The provisions that guide courts relating to specific performance of an agreement are located under Article 396 of the Civil Code.[270] Under this Article, if a shareholder commits a total breach of the shareholder agreement, as RussianCo committed against USLP, then they may pay damages to release themselves from the specific performance of their contractual obligation, "*unless otherwise provided by law or contract.*"[271]

This would seem to be a case that could fit into the "*unless otherwise provided by contract*" caveat.[272] Accordingly, USLP should be able to attempt to assert the rights it has contracted for in the agreement by obtaining specific performance regarding its right to have two members on the board of directors, in lieu of payment of damages.[273] However, it is unlikely that a Russian Court

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265. *Id.* (explaining that under Russian Law a company's charter must conform with JSC Law and thus it can be inferred that if the decision by RussianCo does not violate JSC Law then it also does not violate the company charter).

266. *Id.* (explaining that under the

> Joint Decree of the Plenum of the Supreme Court of the Russian Federation and the High Arbitration Court of the Russian Federation No. 4/8 'On Certain Issues Relating to the Application of the Federal Law "On Joint Stock Companies,"' which clarifies for the lower courts the practical aspects of application of JSC Law . . . JSC Law does not specify a breach of a shareholder agreement as grounds for invalidating a decision of the general meeting).

267. *Id.*

268. Rose, *supra* note 150, at 9-10; *see also* Maximov, *supra* note 251; NOUGAYRÈDE ET AL., *supra* note 235, (explaining that where if a shareholder had a right of claim by contract it is likely that in certain instances, such as director liability that this right would have no legal effect in Russia).

269. Maximov, *supra* note 251.

270. *Id.* (noting that under Article 396 of the Civil Code courts are guided using 2 provisions, first "[t]he payment of a penalty and damages in the event of inadequate performance of an obligation will not release the debtor from specifically performing the obligation, *unless otherwise provided by law or contract*"; and second, "[t]he payment of damages in the event of a failure to perform an obligation and the payment of a penalty for such failure to perform will release the debtor from specifically performing the obligation, *unless otherwise provided by law or contract*").

271. *Id.*

272. *Id.*

273. *Id.*

would provide this right because under Russia's Civil Law system, courts are only able to provide remedies explicitly permitted by statute.[274] There is no piece of Russian legislation that explicitly or even closely provides for this type of remedy.[275] Therefore, it is unlikely that USLP would be able to obtain specific performance under a suit for breach of contract.[276] Thus, even where the Amended JSC has attempted to create avenues for shareholders to have recourse, the Russian Court System does not always provide for the remedy needed.[277]

Before making additional amendments, Russia must change the Russian Civil Code to allow current JSC Law to be enforced.[278] It is wasteful for Russian legislators to amend JSC Law when, under the existing framework, already established provisions are unenforceable.[279] Of primary importance should be the protection of the rights agreed upon in the shareholder agreement.[280] This must include all of the rights, regardless of whether they pertain to the shares being acquired or the shareholders themselves.[281] Furthermore, in the event of a breach of the agreement, shareholders must have faith that the legal framework will ensure that a court will protect their rights.[282] In mature markets throughout the world, shareholder agreements allow for a remedy of specific performance in the event that shareholders' rights are not enforced.[283] Thus, Russia must amend its Civil Code to allow for the annulment of decisions that violate the shareholder agreement or allow parties to sue for breach of contract.[284] In the event parties sue for breach of contract, Russia must amend its Civil Code to expand the remedies available to shareholders.[285] Unless Russia allows for provisions within shareholder agreements to be

274. Rose, *supra* note 150, at 10; *see also* Maximov, *supra* note 251.

275. Maximov, *supra* note 251 (explaining that for a Russian Court to be able to provide this type of specific performance a statute would have to explicitly state something close to where one party has breached a shareholder agreement, the court will provide the remedy of specific performance in the form of compelling the breaching party to vote in line with the breached agreement).

276. Rose, *supra* note 150, at 10 (explaining that "[i]n Russia the form of specific performance granted by a court must be *expressly* permitted by law."); *see also* COMM. ON NEGOTIATED ACQUISITIONS, AM. BAR ASS'N, INTERNATIONAL STOCK PURCHASE ACQUISITIONS 584 (John Grossbauer et al. eds., 2006) [hereinafter CNA].

277. Knyazhev et al., *supra* note 240, at 7-8; *see also* Maximov, *supra* note 251.

278. *See id.*

279. *Id.*; *see also* Gusev et al, *supra* note 229.

280. Rose, *supra* note 190.

281. *See* Knyazhev et al., *supra* note 240, at 7-8.

282. Maximov, *supra* note 251; *see also* RUBIN, *supra* note 258, at 11-31 to 11-38.

283. *See* HAAS, *supra* note 261, at 12-13.

284. *See* Rose, *supra* note 150, at 9.

285. Knyazhev et al., *supra* note 240, at 7-8.

enforceable and provides enforcement of these rights, private equity will continue to invest through offshore holding companies, and direct investment into Russia will never reach its maximum capacity.[286]

B. Problem 2: Corruption

"When asked to describe the people of Russia in a single word, Gavril Romanovich Derzhavin, a Russian Scholar simply said "- *voruyut - (they) steal.*"[287] Derzhavin gave this description of Russians during the 18th Century, and as disappointing as it may seem, the world's investment community still largely regards the description as adequate.[288] In a survey by C5[289] and Squire, Sanders, Dempsey L.L.P., private equity firm managers indicated that the primary reason for writing off deals in Russia was untrustworthy partners, specifically shareholders within the prospective Russian companies.[290]

Consequently, corruption between partner shareholders in prospective Russian companies greatly reduces direct investment from U.S. private equity into Russia.[291] In the context of private equity, the investment is highly structured until exit, and cooperation between the limited partnership and the investee company is particularly important in order to maximize profit and performance.[292] Although there should be a shareholder agreement to ensure cooperation between the parties,[293] as explained in the previous section, shareholder agreements are largely unenforceable in Russia.[294] In addition to the problem of the unenforceability of shareholder agreements, rampant corruption

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286. *Id.*; *see also* Jason Corcoran, *2008 Seen Year that Big Private Equity Hits Russia*, BUS. NEW EUR., Feb. 13, 2008, http://www.businessneweurope.eu/story.php?s=838 (showing that many of the large international private equity firms are contemplating increasing investments into Russia, but are hesitant to invest larger amounts of money because of a lack of an enforcement mechanism, such as an enforceable shareholder agreement).

287. *See* Argalas et al., *supra* note 241, at 18.

288. *Id.*

289. *CIS*, *supra* note 202.

290. *Id.*

291. *See* USDC, *supra* note 6 (noting that "[i]n December, First Deputy Prosecutor General Alexander Buksman estimated that corruption costs the country $240 billion annually and disclosed that prosecutors had uncovered 28,000 cases of corruption among state officials in the first eight months of 2006.").

292. Beddow, *supra* note 130, at 7; *see* Raj M. Desai & Itzhak Goldberg, *The Vicious Circles of Control: Regional Governments and Insiders in Privatized Russian Enterprises* 1, 8 (World Bank, Policy Research Working Paper No. 2287, 2000).

293. *See* Bloom et al., *supra* note 11.

294. Rose, *supra* note 190.

within Russia's judicial system also contributes to the problem[295] and is detrimental to shareholder rights and direct investment.[296]

Corruption is a pervasive problem for the judiciary at both the local and federal levels within Russia.[297] Locally within the jurisdiction of the Russian Federation's eighty-eight subunits, bribes often influence local business decisions in disputes that arise between shareholders of a private equity firm and company shareholders.[298] Within the eighty-eight subunits that comprise the Russian Federation, local leaders often nominate local judges for a bribe.[299] Local Russian Courts are often biased in their interpretation of Russian legislation against foreign investors.[300] Consequently, when a dispute arises with a foreign entity, such as a private equity firm, many times the local judges protect the Russian company and its leaders.[301]

Russian bureaucracy further exacerbates the problem.[302] If an entity accuses a judge of corruption, a regional qualification board must vote by a two-thirds majority to take disciplinary action to have a judge removed.[303] However, upon receiving a complaint concerning a judge, if the board is too busy they may authorize the chairman of the court where the judge presides to evaluate the complaint.[304] It is common for the case to die while in review, as the chairman will assert that the judge in question has been warned.[305] If, however, the chairman reviews the complaint and decides to take action or as in the former case, where a qualification board votes by a two-thirds majority to take action against the judge, then criminal charges can be brought only if the local Prosecutor General approves the criminal proceedings against a judge.[306] As expected this occurrence rarely happens, in part due to the various layers of

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295. Bloom et al., *supra* note 11.

296. *See* USDC, *supra* note 6; *see also* ANDERS ASLUND, RUSSIA'S CAPITALIST REVOLUTION: WHY MARKET REFORM SUCCEEDED AND DEMOCRACY FAILED 186 (2007) (showing that where there is poor corporate governance and no enforcement system because of corruption then partners will be less willingly to invest).

297. *See id.*

298. Bloom et al., *supra* note 11.

299. *Id.*; *see also* ASLUND, *supra* note 296, at 262 (explaining that in Russia bribery is often the main factor in landing a top job, and that "[i]t is hardly an exaggeration in Russia to say that everything is for sale in Russia. People pay bribes . . . to land a good job.").

300. *See* Bloom et al., *supra* note 11.

301. *See* Peter H. Solomon Jr., *Judicial Power in Russia: Through the Prism of Administrative Justice*, 38 L. & SOC'Y REV. 549, 556 (2004).

302. Bernard Black, *Shareholder Robbery, Russian Style*, INST. SHAREHOLDER SERVS. ISSUE ALERT, Oct. 1998, at 3, *available at* http://ssrn.com/abstract=510123.

303. Bloom et al., *supra* note 11.

304. *Id.*

305. *Id.*

306. *Id.*

bureaucracy but also because of a principle from the Soviet past ingrained in many Russian minds, that one must protect one's own.[307] Accordingly, it is very uncommon for a judge on the federal or local level to face removal.[308]

In addition to the problems within the judiciary, there are problems with the governance of the system itself.[309] Federally, the Ministry of Internal Affairs and the Federal Security Service investigate bribery and corruption within the judiciary.[310] However, both oversight entities are themselves perceived to be corrupt.[311] Although the Russian government has continually assured the global community the fight against corruption is a top priority,[312] the corruption-monitoring group Transparency International estimates that corruption has increased seven times since Vladimir Putin came to power in 2001.[313] Internationally, investors' perceptions of Russian corruption magnify the problem and investment suffers.[314] In the context of private equity, both the investor's and the private equity firm's primary concern is their investment in the prospective Russian company and whether their rights as shareholders can be adequately protected by the Russian Courts.[315] Because of the high levels of corruption and lack of protection provided by the judiciary in the interest of their investors, private equity firms structure deals using offshore companies governed by U.S. laws.[316] As a result, Russia misses a vast amount of money that circumvents the Russian system through offshore holding companies.[317]

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307. *Id.*; *see* Judge et al., *supra* note 13, at 307 (explaining that although there are formal rules that judges must abide by, because of their Soviet past the informal rules often carry more weight than the formal ones).

308. *See* Bloom et al., *supra* note 11.

309. *See* USDC, *supra* note 6.

310. *See id.*

311. *Id.*

312. Michael Mainville, *Bribery Thrives as Big Business in Putin's Russia*, SAN FRANCISCO CHRONICLE, Jan. 2, 2007, at A1.

313. *Id.*; *see also* ASLUND, *supra* note 354, at 272 (noting that "corruption, which declined during Putin's first years of structural reforms, started rising with the renationalization drive after 2004").

314. Mainville, *supra* note 312, at A1 (noting that "[i]n a Gallup poll of 101 countries, released on Dec. 5, [2008] Russia was perceived as the third-most corrupt nation, after Morocco and Romania") (text added); *see also* Fianna Jesover, *Corporate Governance in the Russian Federation: The Relevance of the OECD Principles on Shareholder Rights and Equitable* Treatment, 9 PRACTICED-BASED PAPERS BLACKWELL PUBS 79, 79 (2001) (explaining that corruption in the Russian legal framework "have resulted in a general climate of uncertainty and widespread opportunism, which had a negative impact on investment").

315. Mainville, *supra* note 312, at A1.

316. *See* Russia: Digest, *supra* note 7, at 1.

317. *See* USDC, *supra* note 6; *see also* Langer et al., *supra* note 5, at 6.

In order to increase direct investment it is apparent that Russia must first confront the rampant corruption in its judiciary before making additional amendments to JSC Law.[318] Judges must be held accountable for their actions.[319] Although it seems as though oversight should come from the federal level through the Ministry of Internal Affairs and the Federal Security Service, this already has proven ineffective.[320] This is partially due to the sheer size of the Russian Federation, and the inability of the federal entities to provide oversight to courts within eighty-eight separate subunits.[321]

Therefore, Russia should implement changes at the local levels.[322] First, judges should not serve the subunit where they receive their nomination.[323] Instead, they should be placed and serve in a different subunit.[324] This would help to alleviate local bias against foreigners and not allow local leaders and businessmen to manipulate judges they have nominated.[325] Second, if an entity accuses a judge of corruption, instead of requiring a two-thirds majority vote by the regional qualification board, the voting requirement should be a simple majority.[326] This would not only ease the voting threshold required to take action against corrupt judges, but it would also make disciplinary action to have a judge removed more efficient.[327] Finally, if a regional qualification board is too busy to hear the complaint against a judge, they should not be able to authorize the chairman of the court where the judge presides to evaluate the complaint. There is too great a chance for corruption in this case.[328] Instead, the complaint against the judge should be heard either by another impartial regional qualification board or by a chairman of another court outside of the particular judge's subunit.[329]

C. Problem 3: The Judiciary

It is obvious to U.S. private equity firms investing in Russia that corruption may be a potential obstacle within the judiciary,[330] but an equally serious, yet

318. *See* USDC, *supra* note 6; *see also* Lerner et al., *supra* note 249, at 223 (noting that there is a relationship between increasing financial markets and a strong legal system).

319. *See* Osugi, *supra* note 242, at 6.

320. *See* USDC, *supra* note 6.

321. *See* Russia: Digest, *supra* note 7, at 2.

322. *See id.*

323. Solomon, *supra* note 301, at 552.

324. *See* Bloom et al., *supra* note 11.

325. Solomon, *supra* note 301, at 552.

326. *See* Bloom et al., *supra* note 11.

327. *See id.*

328. *Id.*

329. Solomon, *supra* note 301, at 552.

330. *See* USDS, *supra* note 9; *see also* Bloom et al., *supra* note 11.

less apparent threat to investment is the differences in legal systems between the United States and Russia.[331] This is largely a result of Russia having a civil law system[332] where statutes are more important than precedent.[333] In resolution of disputes, judges interpret legislation rather than looking to earlier jurisprudence.[334] In their interpretation of legislation, judges take a literal approach and often are not concerned with the substance of a case.[335] U.S. limited partnerships are often accustomed to a common law approach to commerce and find the interpretation of Russian laws by courts to be inconsistent.[336] Ironically, Russian businessmen also find the web of conflicting laws and their interpretation to be inconsistent.[337] This is due to a number of reasons.

First, during the 1990s, there was a proliferation of legal reform in the Russian Federation. Most legislation is quite recent; consequently, judges are still becoming acclimated to the new statutes.[338] It does not help the situation that there have been new amendments to JSC Law in 1996, 1999, 2001, 2002, 2003, 2004, and 2006.[339] Thus, weak enforcement is partially due to the failure of existing Russian judiciary to keep pace with the many amendments.[340]

Second, the laws are complex and multilayered.[341] This is not conducive to consistency where the Russian Federation is comprised of eighty-eight subunits, twenty-one republics, forty-nine regions, ten autonomous districts, six territories, Moscow, St. Petersburg, and one autonomous region.[342] Furthermore, each of the eighty-eight subunits are competent to enact legislation, but must follow matters that fall under federal exclusive jurisdiction.[343] Moreover, many judges come from the Soviet era of Communist economic ideas and this makes it especially difficult to master the complex issues associated with laws dealing with economic statutes and corporate governance.[344] Even where a judge has an

331. Rose, *supra* note 190.

332. *See* USDS, *supra* note 9.

333. CNA, *supra* note 276, at 584; *see also* Russia: Digest, *supra* note 7, at 1.

334. *See* Russia: Digest, *supra* note 7, at 1.

335. *Id.*

336. *See* CNA, *supra* note 276, at 584.

337. *See Smoke*, *supra* note 229, at 27-29.

338. *See* Russia: Digest, *supra* note 7, at 1.

339. Lazareva et al., *supra* note 4, at 34.

340. OECD, *supra* note 7, at 16.

341. *See* Russia: Digest, *supra* note 7, at 6.

342. *See id.* at 2.

343. *Id.*

344. OECD, *supra* note 7, at 16; *see also* Lerner et al., *supra* note 249, at 226, 228 (noting that Judges may have a hard time dealing with complex contract features tied to control and ownership of shares and may be "suspicious and indeed hostile to such transactions").

understanding of the economic concepts, it is likely that they have not become fully trained in the law as many newly appointed judges do not complete their education before being appointed to the judiciary.[345]

In addition to the problems within the judiciary, the infrastructure surrounding it is problematic as well.[346] There is a general lack of resources provided for the judicial system in Russia.[347] Funds are often not available for fundamental functions within the courts such as providing payment of jury members, postage, and calling witnesses.[348] In addition, many courts have trouble functioning properly because of understaffing due to the inadequate funding.[349] Thus, even if an investor who brings suit finds an impartial judge who understands the law, there is no guarantee that the judge will have the infrastructure in place to see that their ruling is carried out.[350]

There are three key changes that Russia must implement to strengthen its judiciary.[351] First, it must increase funding to the judiciary.[352] This will serve two purposes.[353] It will allow the judiciary to have the infrastructure in place to function properly, and judges will be less likely to take bribes if they receive a greater wage.[354] In addition, by receiving a higher wage the judges should receive more respect.[355] This will not only create judges who value their positions and would not want to jeopardize their future by taking bribes, but also will increase competition for judicial candidates in the future.[356]

The second key is that Russia must increase consistency in its judges' rulings[357] within the aforementioned eighty-eight subunits, twenty-one republics, forty-nine regions, ten autonomous districts, six territories, Moscow, St. Petersburg, and one autonomous region, which together make up the Russian Federation.[358] While this seems daunting, if Russia prohibits each of the eighty-eight subunits from enacting their own legislation and follows a true civil law

345. OECD, *supra* note 7, at 17.
346. *Id.*
347. *Id.* at 17; *see also* Solomon, *supra* note 301, at 552.
348. OECD, *supra* note 7, at 17.
349. *Id.* at 16.
350. *Id.* at 17.
351. *See id.*
352. *Id.* at 17.
353. OECD, *supra* note 7, at 17.
354. Solomon, *supra* note 301, at 552.
355. OECD, *supra* note 7, at 17.
356. *Id.*
357. *See* Solomon, *supra* note 301, at 562.
358. *See* Russia: Digest, *supra* note 7, at 2.

system under exclusive federal jurisdiction,[359] then there will inevitably be more consistency in judges' rulings.[360]

The third and most important key is that Russia must not enact any additional amendments.[361] JSC Law is complex and multilayered.[362] The Russian Legislature has made amendments in seven out of the last ten years.[363] Judges need time to become accustomed to new statutes.[364] The last thing judges from a post-communist era in an already ineffective system need is a new set of economic-based legislation.[365] Thus, it is in the best interest of the judiciary, and Russia for that matter, not to enact additional amendments to JSC Law.[366]

VI. CONCLUSION

Private equity investments will continue to increase in Russia.[367] Additional amendments to JSC Law will neither increase direct investment into Russian companies nor provide additional protections for shareholders.[368] In order to increase shareholder protections, Russia must amend the Civil Code to allow for provisions within shareholder agreements to be enforceable.[369] Furthermore, it must expand the remedies available to parties when shareholders breach agreements.[370] Finally, and most importantly, Russia must confront corruption within its judiciary before enacting additional amendments.[371] Although daunting, the best strategy for Russia is to reform its judiciary at the local levels.[372] Until these changes are made, U.S. limited partnerships will continue to invest through offshore holding companies, and Mother Russia will continue to lose rubles.[373]

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359. *See id.* at 5.
360. *See* Solomon, *supra* note 301, at 562.
361. OECD, *supra* note 7, at 7-8.
362. *See* Russia: Digest, *supra* note 7, at 6.
363. Lazareva et al., *supra* note 4, at 34.
364. *See* OECD, *supra* note 7, at 16.
365. *See id.*
366. *Id.* at 7-8.
367. NIELSEN, *supra* note 2.
368. Knyazhev et al., *supra* note 240, at 7-8.
369. *See id.*
370. Maximov, *supra* note 251.
371. Bloom et al., *supra* note 11.
372. *See* Russia: Digest, *supra* note 7, at 6.
373. Rose, *supra* note 150, at 9-10.